

## **A Different Kind of War ... *political reset will remain but Russia wants to remain open to, and for, business***

*“Let me warn you, if you start chasing after views, you’ll be left without bread and without views”*

**Nikolai Gogol**

**Russia is in a new kind of war ...** In the past, if countries disagreed with one another, they sent a gunboat or threatened war. Now they impose economic sanctions. On this basis, Russia is already in some form of war with the West. In a way this is good news, because it makes it less likely there will be an actual physical conflict. All the posturing and aggression can be played out on the economic front.

**... which will be prolonged ...** The conflict is having an impact on Russia’s debt markets and on some industries in Europe. But the pressure is not yet costly enough on either side so there is little pressure for it to end. No side looks like backing down soon.

**...oil and underlying economic weakness have caused greater damage.** There has been very little push-back in Russia to the ban on food imports, although surveys show a growing public concern about rising inflation. The rapidly fall in the oil price and an already weakening ruble, from early 2013, are causing much greater damage to the economy.

**Russia is relatively well prepared.** Russia has a strong balance sheet – at least enough to cover the expected budget deficit and all foreign debt obligations until end-2015 without accessing new external capital or debt – and the weakening ruble provides a lot of protection to the budget. It also helps promote the policy of import substitution, although this can only have a limited impact. The West cannot impose Iran or Iraq-style sanctions against Russia, because this would starve Europe of gas and it would reverse the recent oil price fall. Russia can switch some demand for manufactures to China which would have some negative impact on elective EU industries.

**Putin’s goal.** Putin has made very clear that he wants to change the whole international political system. His view is that the current one is rigged by the US, and he wants to level the playing field. This conflict offers the opportunity to cause some rift between the US and China and, if the EU drops sanctions but the US does not, with Europe. Putin prefers to shift global decision making towards the G20 and with the BRICS groups having a sizeable influence.

**No pressure for change.** Putin’s forceful external policy is based on rock-solid support at home from both the electorate and the elite. There is little chance of a Krushchev-style ouster, and even if Putin is removed by an accident, we expect that the system would elevate a similar individual to take his place.

**Not a new Cold War.** Putin is rejecting the West’s international system, but not its economic one. He wants access to their markets, he wants to import their goods, and he wants their companies to invest in his economy. None of that has changed. He will keep his capital account open (his elites demand it) and his government will not discriminate against foreign businesses.

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## Lifting sanctions seems a long way off

*“The enemy”, retorted Yossarian with weighted precision, “is anyone who’s going to get you killed, no matter which side he is on”*

Joseph Heller, Catch-22

The three key points about the current state of affairs are:

- US sanctions will not be lifted anytime soon and may worsen if the republican-led Congress gets its way
- EU sanctions may not be renewed after the 12-month expiry, but any benefit from ending EU sanctions will be limited if US sanctions remain, especially in the financial sector
- Putin wants to change the system of international law
- The Kremlin seems to believe that the West will back down before Russia does

### Sanctions will not be lifted anytime soon

**No real effort to lift sanctions by either side.** Sanctions will not be lifted early because neither side is pushing hard to have them removed – so far they are low level, and low impact, more a statement of intent than intended to bite hard. Of course, the financial sector sanctions are the more serious and have at least contributed to the ruble weakness while making it tough for Russian businesses to access foreign debt and trade credits. Thus far, the general population in Russia has not been particularly affected, albeit prices are rising faster partly due the sanctions impact on the ruble, while in some ways they actually help Putin attain some domestic policy goals. The Russian counter-sanctions are perceived to be more serious in terms of their affect on some Western businesses and the Russian economy, but these will only go when Western sanctions are lifted.

### Sanctions are not the main problem

**Oil price collapse is more serious.** The sanctions imposed have been much lower impact than feared. The rapid collapse in the price of oil has had a much greater effect on the ruble, inflation and confidence in the economy. Russia’s actions in Crimea could be equated to Iraq’s invasion of Kuwait, or Argentina’s invasion of the Falklands, in terms of their violation of sovereign territory. If a non-nuclear nation had done something similar, it is highly likely that there would have been a military response. More recent examples of sanctions were those imposed on Iran, Iraq and Serbia, which amounted to a virtual banning of trade and financial flows with those countries. For instance, Iraq invaded a foreign territory, then withdrew, but still had to suffer a UN office that reviewed every single import and export contract, with exports being allowed only to finance essential imports. 25% of exports proceeds were allocated to war reparations. Iran was cut off from SWIFT in 2012 and Serbia was bombed by NATO.

**Russia - Macro Outlook**

	2013	Base Case Assumptions				Pessimistic Assumptions		
		2014E	2015E	2016E	2017E	2015E	2016E	2017E
Growth, real % YoY	1.3%	0.5%	-0.3%	0.5%	3.0%	-2.0%	0.0%	1.5%
CPI - year-end, % YoY	6.5%	9.3%	8.0%	7.0%	6.0%	8.5%	7.0%	6.0%
Gross fixed investment, real % YoY	-0.3%	-3.5%	-3.0%	2.0%	4.0%	-6.0%	-3.0%	2.5%
Retail sales, % YoY	3.9%	2.0%	-0.5%	1.0%	3.0%	-0.5%	0.5%	2.5%
Unemployment, % EOP	5.6%	5.0%	5.0%	4.9%	4.9%	5.0%	4.9%	4.9%
Budget, balance % of GDP	-0.5%	0.1%	-2.5%	-1.5%	-1.0%	-3.0%	-2.0%	-2.0%
Current account, % GDP	1.6%	4.0%	3.5%	2.0%	1.5%	3.5%	2.0%	1.5%
RUB/US\$, year-end	32.9	50.0	50.0	45.0	44.0	60.0	50.0	50.0
RUB/EUR, year-end	45.3	63.0	63.0	57.0	55.0	75.0	63.0	63.0
Urals, US\$ p/bbl, average	\$108.0	\$100	\$78	\$80	\$85	\$75.0	\$75.0	\$80.0

Source: State Stats Agency, Central Bank, Macro-Advisory estimates

**No global sanctions on trade with Russia.** By contrast, there have been no global sanctions on trade with Russia. The sanctions initially were directed against individuals, and there have been very few actual confiscations of property (the most prominent being the freezing of Italian assets including holiday villas belonging to Arkady Rotenberg, who is on the sanctions list as a close associate of Putin's). These individuals generally have well founded structures of offshore holdings that make it hard to prove their final ownership of assets, and Western law enforcement has long been unable to pierce this secrecy.

**Almost no Western lobby for lifting sanctions**

**Relatively few Western victims of Western sanctions.** There are relatively few identifiable Western victims of the Western sanctions. There will be little public sympathy for the various businesses like family offices and offshore legal firms serving oligarchs and their interests in London and Geneva and elsewhere. Global exposure to Russian equities is low, and the Russian investment banking and asset management industries also have minimal Western footprints. Lobbying organizations like the US-Russia Business Council, the American Chamber of Commerce and the European Business Association have spoken out against sanctions, as have some Italian businesses, but their grievances do not outweigh the anger against Russia, especially since the downing of MH-17 in Eastern Ukraine. The Russian counter-sanctions are a different matter. These were designed to affect the powerful EU agricultural lobby, and seem to have had some success.

**European agriculture to lose EUR6.7 bln.** Spanish farmers dumped potatoes outside supermarkets in protest. EU agricultural exports are about 10% of annual agricultural sales (<http://themoscowtimes.com/business/article/eu-allocates-more-than-150-million-to-help-farmers-offset-russia-s-import-ban/508111.html>). ING estimate that the total loss to European agriculture will be EUR6.7 billion and some 130,000 jobs may be lost. The EU has earmarked a EUR290 million fund to compensate farmers, but 80% of this went to Polish farmers.

**Anti-Russia sentiment offsets any sympathy for farmers.** On the other hand, the anti-Russian climate in the West is still strong enough to counteract any sympathy for the farmers. Although Russia is an important market, it should be possible for these farmers to find other markets over time, and the initial protests seem to have died down. This may reflect a hope that the situation will soon be resolved and the Russian sanctions lifted. We expect that these hopes will not be realized, as the Russians will not lift their sanctions until the EU lifts theirs, and even though the expiry date is end July, there is still a risk of a renewal.

### **Putin won't back down**

**Crimea appears to be non-negotiable.** Only recently (24 September), Obama said that sanctions would only be lifted once Russia withdrew from Ukraine (<http://nationaljournal.com/white-house/obama-says-u-s-would-lift-sanctions-if-russia-pulls-back-in-ukraine-20140924>).

This was reiterated by Victoria Nuland on 9 October 2014 (<http://iipdigital.usembassy.gov/st/english/texttrans/2014/10/20141009309802.html>). What is not clear here is whether "Ukraine" includes Crimea. If it does, then the US will have to wait a long time, as all current Russian rhetoric treats Crimea as an integral part of Russia, which they are no more likely to give up than, say, Kaliningrad. As for Russian involvement in eastern Ukraine, since the official Russian position is that there are no Russian troops deployed there, it would be hard for them to state an intention to withdraw.

### **Even if Putin wanted to step back, the military maybe less willing**

**Relationship between Russia's government and military obscure.** The relationship between Russia's political leadership and its military is complex and opaque. As a result, it has not attracted a lot of analysis, especially in the West. It seems that the Russian military does not have an independent political agenda (unlike in Turkey, Burma, Argentina, or maybe even China). It does need resources, and if it lacks these, it will become ineffective. Putin was already starting to allocate more funds to the military when he was Prime Minister and this rapid increase in military spending was one of the reasons for Alexei Kudrin resigning as Finance Minister in 2011.

**Russian military has proven itself loyal to civilian government.** However, even in the darkest days of the 1990s when the military was starved of funding, there was no question of direct intervention by the military in internal politics. In 1993 the military acted to quell an anti-Yeltsin uprising, even though many of its commanders probably sympathized with the protestors. In general, the Russian military will do what it is told by the civilian power, and has always been reluctant to take up arms against its own citizens.

**Regaining Crimea scored points with the military.** The regaining of Crimea was tactically an easy and cheap way to score points with the military. Sevastopol is an important naval base. In 2003, Putin instructed the General Staff to investigate the possibility of building an alternative naval base on Russian territory. US\$480 million was allocated to rebuild Novorossiysk, but not much seems to have come from it. Novorossiysk suffers from high winds, and there is also potential congestion from tanker traffic. Another factor that makes Crimea important to Russia is that in the Soviet Union, many retired Russian military personnel settled in Crimea, and these people have suffered relative to their comrades who stayed in Russia since Ukraine became independent. Leaving Crimea would be seen as another betrayal of them, and they now all have Russian passports.

**Russian military has shown total unwillingness to cede territory.** As a result, giving Crimea back would be costly in terms of domestic politics. Whatever the legality of its obtaining, Russia has been very unwilling to cede territory since the collapse of the Soviet Union, as evidenced by the long-running dispute with Japan over the Kurile Islands, which have much less strategic importance than Crimea. There is no carrot big enough to tempt Putin to give back Crimea, given how much it would cost him domestically, and the mere removal of sanctions would not be enough.

## **2016 US elections will have a strong anti-Russia theme**

**US stance on Russia unlikely to soften.** There is little likelihood of the West's attitude softening in the short run, if Russia's policies don't change. President Obama has some leeway to step back, given that he does not have to stand for re-election, but he does not have much to gain from this. If he wants to protect his legacy, it seems he will adopt a hard-line stance on Russia in return for protection of, e.g. Obamacare.

**US Congress is expected to be very anti-Russia.** The US Congressional mid-term elections saw the Republican Party gain control over both the House of Representatives and the Senate. It means that such vehemently anti-Russia Republicans may push through legislation to both increase US military support for Ukraine and also embody sanctions against Russia for a ten-year period. That really would usher in a form of Cold-War II. Of course President Obama would still have the right to veto any legislation and would probably be under pressure from the EU to at least block the proposed ten-year legislative sanctions. But, as stated, the situation is very complicated, not least because of the nature of US domestic politics, and a lot of uncertainty hangs over the issue.

## **Hillary Clinton is vulnerable to attack**

**Expect anti-Russian rhetoric in 2016 US Presidential elections.** The next Presidential elections are likely to feature a lot of anti-Russian rhetoric on both sides. Assuming that Hilary Clinton will be the Democrat candidate, she is likely to be accused of being soft on foreign affairs. Clinton is expected to counter this with aggressive anti-Russian rhetoric (she has already compared Putin to Hitler).

## Clinton also needs to live down the “reset” with Russia

**Political support for removing US sanction unlikely.** Clinton opened herself up to these allegations by her high-profile “reset” button with Russia, which now appears bungled from the start. Although the Obama administration did seem genuinely committed to better relations with Russia than its predecessor, the reality of America’s position in the world is that it does not want to share its pre-eminence with anyone. This is what dominant global powers have always done. The Russians have seen US administrations come and go, so they simply used the moment to extract what concessions they could. As a result, Hillary Clinton will have to redouble her anti-Russian rhetoric to live down the “reset” button, and her Republican opponent will match her. In this sort of atmosphere it is hard to see any political support for removing US sanctions.

## This is not the same as restoring the Cold War

**Russia has not attained full pariah status, nor will it.** It is more likely that even if the current phase of uneasy peace is maintained rather than resolved, Russia will not attain a full pariah status. The situation in Ukraine is unpredictable, as is Russia’s potential response. But the Kremlin has repeatedly stated that Russia will not annex eastern Ukraine. However, it is clear that assistance will be available to the rebel governments in those regions to stop Ukraine invading if necessary.

**No escalation over Crimea.** While not exactly backing down, the view in Russia is that the West is more likely to accept the status quo, much as it did in regard to South Ossetia and Abkhazia, two breakaway regions of Georgia that de facto joined the Russian Federation after the war with Georgia in 2008. Despite the principles of international law dictating that all violations of sovereign territory are equal, the fact is that an all-out war with Russia over Crimea is out of the question for Ukraine, let alone NATO. Obama was elected on a promise that he would take troops out of Iraq, and he is hardly likely to initiate another long-term conflict during his last two years in office.

## Europeans have closer economic ties

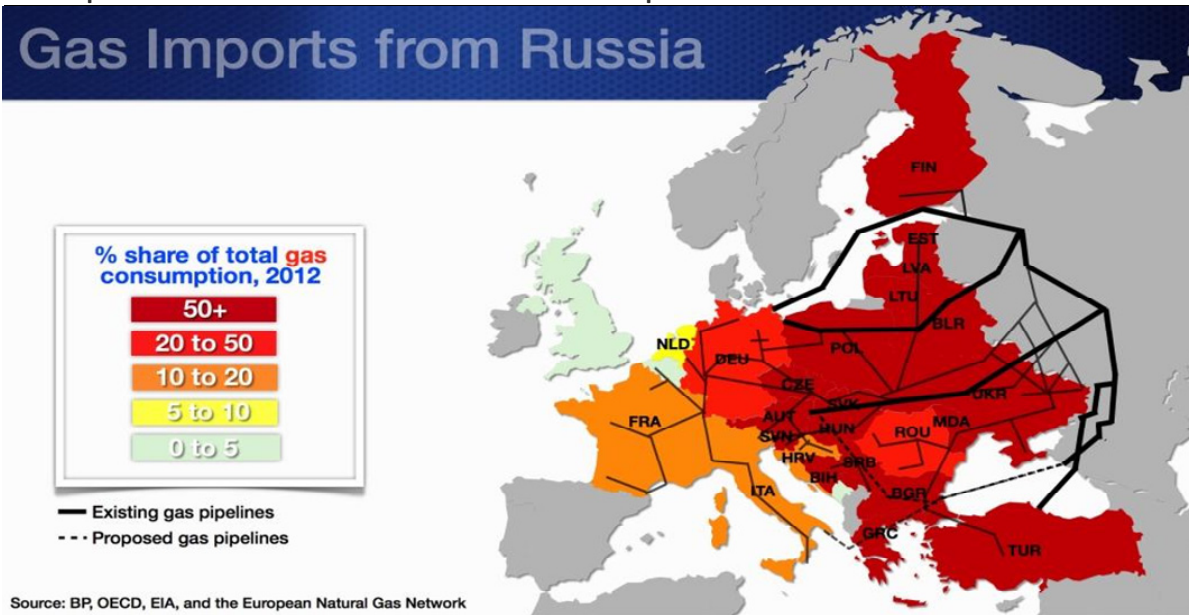
**Europe and the US have different interests.** Russia sees that the US and European agendas differ, and also that it is possible to divide the EU to prevent it reaching the unanimity that is required for major strategic decisions. As long as some European states realize that they have an interest in a long-term strategic relationship with Russia, then they can be persuaded to dissent from the US’s sanctions. Germany has been able to show leadership to unite Europe, but it has to expend political capital to do so, and at some point this capital will be required for issues that are closer to home.

**Europe has closer economic ties to Russia.** The US can afford to impose headline-grabbing sanctions against Russia because there are very few major domestic economic sectors that suffer from them or the Russian counter-sanctions. And in any case, anti-Russian sentiment is so high that the political gains from Russia-bashing outweigh the losses inflicted on these businesses. Europe however really is close to Russia economically, and a large part of European business would suffer without Russian gas, or without Russian export markets.

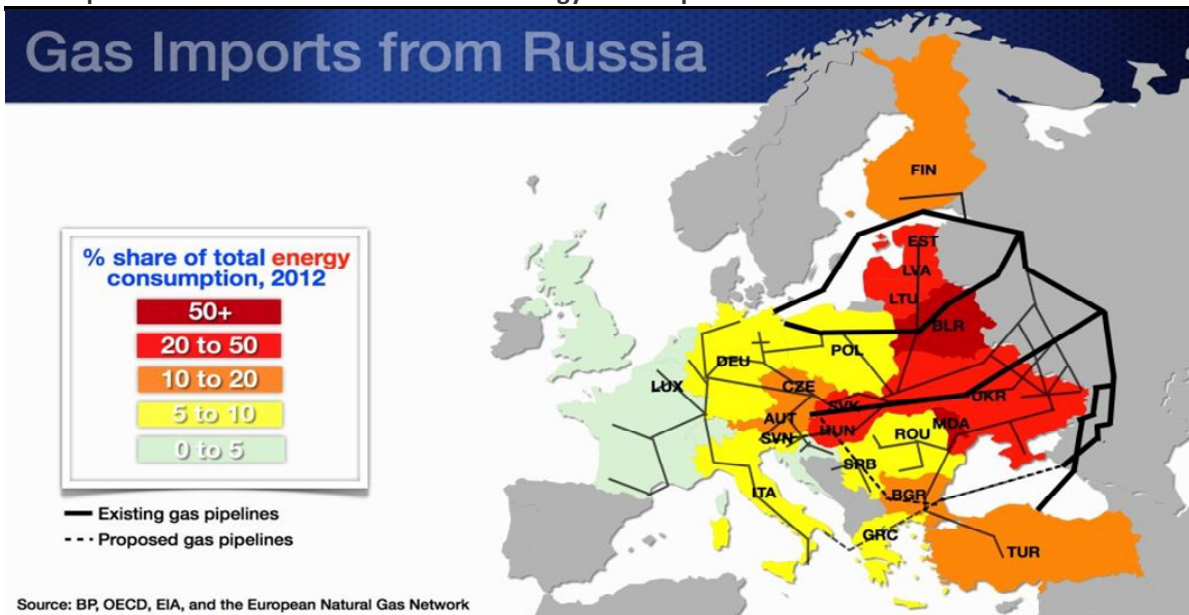


**EU has heavy reliance on Russian gas.** Poland and Slovakia both get just about all their gas from Russia, and so cannot afford to cut off all ties to Russia. If Russia were cut off from SWIFT (as was threatened by one EU summit) then it would be hard for Russia to sell gas to these countries. Most importantly for the EU, Germany is still highly dependent on Russia, despite a decades-old policy to wean the country off fossil fuels. Given the fears that Europe is sliding towards deflation because of fiscal austerity in the periphery, an energy supply shock would be very dangerous.

**Gas Imports From Russia – % Share of Total Gas Consumption**



**Gas Imports From Russia – % Share of Total Energy Consumption**



**Magnitude of Russia's ban on EU food imports unclear.** Russia with its 144 million people (including Crimea) is an important export market for Europe. Its dominance of the Eurasian trade agreement means that it can also threaten to cut off Belarus and Kazakhstan from European exporters. It has already done this for food exports – there was a large initial impact as shipments had to be turned back and buyers urgently found. Since then, it is not clear how much damage has been done by the Russian ban – media comment suggests that things are not that bad, and Putin may have over-estimated the importance of Russia for European farmers. However, at the margin, this should push food prices down in Europe, which again will threaten the region with deflation.

### **Other issues like the Middle East are likely to become more important**

**Attention may get diverted from Ukraine.** Another reason why attention may shift away from Ukraine will be the intrusion of other issues, such as the ISIS insurgency or the Ebola outbreak. It may be that Russian assistance is needed for these, and we can expect the Russians to use whatever leverage they have. Since Ukraine poses no direct threat to US interests, then it is likely that its attention will move elsewhere, although it does seem likely that Russia will be a major issue during the next Presidential election campaign.



## Putin's has a broader goal

*"And those who were seen dancing were thought to be insane by those who could not hear the music"*

Friedrich Nietzsche

### Post-Crimea speech was programmatic

**Putin's Crimea speech was very clear.** Putin's speech to the joint houses of Parliament following the referendum to include Crimea in the Russian Federation needs to be read in its entirety to understand how it marks a break with the past (<http://eng.kremlin.ru/transcripts/6889>). It is much clearer than the comments made at the Valdai Club meetings in Sochi in October. It sets out a list of the promises that were made to Russia and broken (in Putin's view). It describes a world of international institutions and law that is designed to benefit the United States alone, and it clearly states Putin's intention to change that system. For instance, Putin cites a statement to the UN by the United States to the effect that: *"Declarations of independence may, and often do, violate domestic legislation. However, this does not make them violations of international law."*

**Grievance stretches back to Balkans War.** This was originally stated in regard to Kosovo, where Russia feels that it was not given a full voice in the consultation process, and its concerns were ignored.

**Critical of US "Exceptionalism".** *"Our Western partners, led by the United States of America, prefer not to be guided by international law in their practical policies, but by the rule of the gun. They have come to believe in their exclusivity and exceptionalism, that they can decide the destinies of the world, that only they can ever be right. They act as they please: here and there, they use force against sovereign states, building coalitions based on the principle "If you are not with us, you are against us." To make this aggression look legitimate, they force the necessary resolutions from international organisations, and if for some reason this does not work, they simply ignore the UN Security Council and the UN overall."*

**China: A loose coalition of the unwilling?** The same speech thanked China for their support. Without China, Russia's isolation would put it in a difficult position. However, Putin has managed to play on China's own grievances with the United States to create a loose coalition of the unwilling. He has tried to bring in Latin American and African states through the creation of the BRICS Development Bank as an alternative to the World Bank, with funds to be provided with very different policy conditionality. Now that Russia is no longer part of the G7 (probably), the G20 may be seen as a broader framework for international collaboration. Then again, the obviously frosty reception Putin received at the recent G20 summit in Australia raises a question mark over that assumption.

## Russia feels it has nothing to lose

**Putin's course is a gamble.** Putin appears to be gambling that the economic interests of the European Union will force them to deal with Russia, despite their greater ideological ties to the US. This assumption looks set to be tested in 2015 if the EU wavers on sanctions renewal while the US stands firm. He is gambling that China will be willing to annoy its largest export market. He has nothing to lose in that the worst case will be the status quo – Russia is already near to being a pariah state as far as Washington is concerned. He must fear losing the European gas markets over the long term, but then the Europeans have had over 10 years of warnings to wean themselves off Russian gas, and have done little. In reality, the only long-term alternative to Russian gas is to import from Iran; hence, possibly, the more accommodating stance in the nuclear talks. Still, any effort to bring Iranian gas to Europe is a decade long project rather than anything much sooner. The biggest threat to Russia is a lower oil price, but Putin knows that the Gulf States need an oil price around US\$90 per barrel on average to fund their social and defense obligations, all of which have greatly increased since the so-called Arab Spring. There is also the comforting assumption that US tight oil and gas, especially new projects, become uneconomic at lower oil prices.

## Sanctions help Putin with domestic policy

**The greater impact on the economy has come from lower oil and weak growth.** The impact of Western sanctions on the Russian economy is relatively light, so far. By far the greater impact has come from the rapid decline in the exchange rate of the ruble which has had more to do with the falling oil price and weaker underlying economy than sanctions specific. The ruble fell 20% against both the US dollar and the Euro from January 2013 to end February 2014 even though the oil price held steady at \$108 per barrel and before sanctions were threatened. Since the start of sanctions in March 2014 to August, i.e. just before the oil price started to slide, the ruble slightly appreciated.

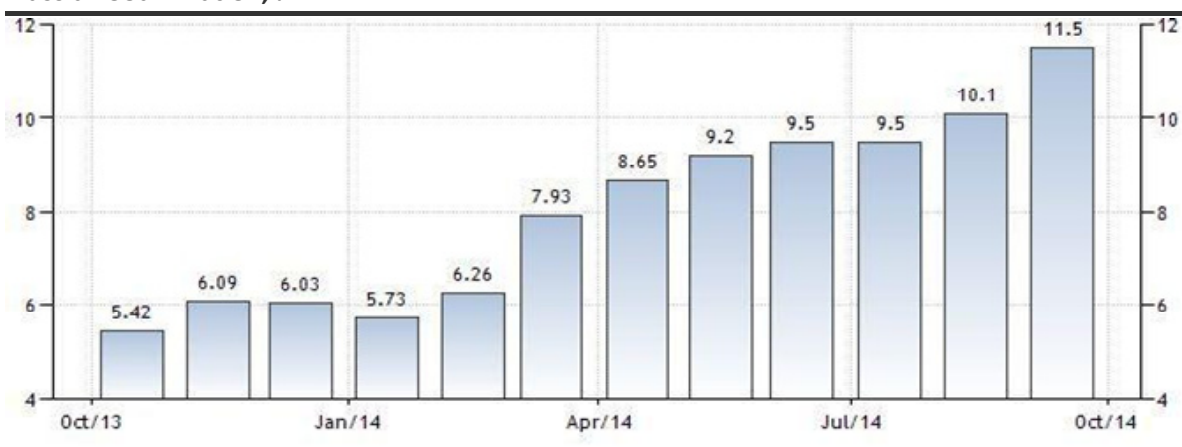
Growth is weak, predicted at 0.5% in 2014, down from the 1% or so predicted at the beginning of the year. This year was always going to be difficult because of a lack of past investment. The biggest threat is the possibility that Russia will remain cut off from western financial markets. On a broad view, Russia can weather these storms by using its reserve funds, and may eventually be able to seek alternative financing from non-sanction countries. Russia has US\$180 billion in its sovereign funds, which form part of the approximately US\$420 billion in cash in its Central Bank reserves, compared with US\$150 billion or so falling due between now and the end of 2015 (*MS figures quoted in Moscow Times*). Capital flight reached US\$75 billion in the first half of the year, but was US\$13 billion in the third quarter. Of course not all of that \$420 billion is actually available to cover debt and the expected growing budget deficit in 2015 as the oil price remains weak. In reality, the total available reserves cover all expected obligations up to end-2015 or mid-2016, but with little to spare for investment spending or to fund other growth boosting programs.

**Self-sanctions to prove a greater threat.** On a micro level, the very obvious contagion from official sanctions is that most Western financial institutions have closed off credit to any Russian counterpart and toughened scrutiny to avoid the remotest chance of being caught up in sanctions. One example is that London IPO lawyers now require confirmation that a new placement will not be sold to sanctioned Russian counterparties. There is no requirement for this under EU sanctions, but over-cautious lawyers are imposing extra restrictions on their own initiatives.

**Sanctions may reduce capital flight.** In theory, the Western sanctions might help reduce capital flight, as they make it harder for Russian officials and oligarchs to find a home for their money outside Russia. This seems unlikely – there are entire industries devoted to helping rich Russians hide their money from the authorities both inside and outside Russia. The main problem imposed by the new sanctions is uncertainty. Anecdotally, it is already becoming much harder for any Russians, sanctioned or not, to put their money in Western banks. However the banks are waiting for the new rules to bed down and find equilibrium in terms of what is acceptable to the regulators, and once the dust settles the doors will very likely open again.

**Fall of account deficit due to Russians converting savings to dollars and the low oil price.** Sanctions are not likely to make the Russian owners of flight capital any more patriotic. Nor is it very likely that sanctioned individuals are patriots without any offshore assets. The fall of the capital account deficit is more due to the fact that Russians with ruble savings have already converted as much of them to dollars as they can, and also because the lower oil price means less capital to export.

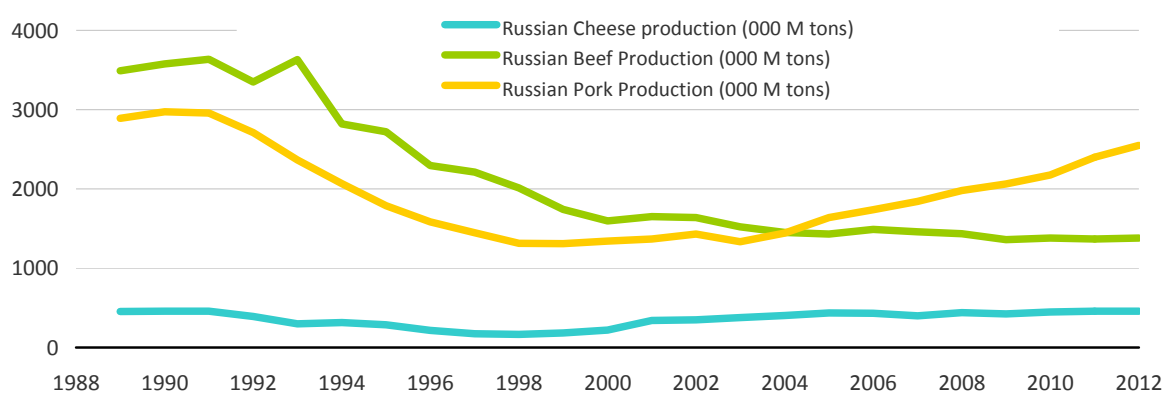
**Russia Food Inflation, %**



Source: <http://www.tradingeconomics.com/>

**Boost agriculture and food security.** The most harmful sanctions (for the Russians) are those imposed by Russia itself. Food inflation was already running at double figures in September, largely because cheaper European meats and vegetables are not available to the Russian consumer. Russian rhetoric is that this will encourage investment in domestic production to enhance Russia’s long-term food security. This is over-optimistic on a short to medium term basis. Years of massive support to the Russian agriculture have done little to unlock Russia’s food production potential. The issue is not demand or financing, but Russian bureaucracy, which makes it very hard for farmers to get their food to the final consumer. At best, these sanctions might encourage more inward investment for import substitution, but this is a long term program.

**Russian Agriculture Production 1988-2014**



Source: Central Electoral Commission of Ukraine

## Conflict with West calms internal politics

*“Moral maxims are surprisingly useful on occasions when we can invent little else to justify our actions”*

Alexander Pushkin, Tales of Belkin

**Two threats to the status quo.** The Russian political landscape has settled since the protests around the Duma elections of 2011 and the Presidential elections of 2012. However, despite this, there are two general threats to the status quo: grassroots protest and internecine struggles within the elite. However, it seems clear enough that Putin has neutralized these two threats to his position. It is possible that Putin himself may initiate changes, although one of his key policy goals is political stability. If he does, these will probably occur closer to the next Presidential elections in 2018.

## No Major Strategic Internal Goals

**Preservation of political and economic stability.** Many of the strategic goals that Putin laid out in 2000 when he first became President have been materially adapted or abandoned, as they proved either unattainable or contradictory to short-term tactical considerations. So, for example, the promises to strengthen civil society and the judiciary have been forgotten, as these impeded the ability to deal with political opposition from the oligarchs and from street-level protests. Putin’s main strategic goals are now the preservation of stability, both political and economic, and the assertion of Russia’s right to act as a Great Power on a multilateral international stage.

## Putin is basically happy with the status quo

**Three conditions.** Historically a successful Russian ruler needs to do three things:

- Assert absolute authority at home
- Prevent moves by the regions for more independence or separatism
- Stop invasions from outside

Putin’s first Presidency was devoted to the first two goals. There has not been any real threat of the third, although NATO expansion is seen as threatening invasions in the future.

**Having no debt prevents IMF from interference.** In keeping with the theme of modern warfare happening on an economic rather than a physical battlefield, an IMF debt structural adjustment program is a form of invasion. If you have no debts, then you need not fear officials from the IMF telling you how to run your economy. Putin learned early on as Prime Minister that large foreign debts require a country to obey the IMF, and does not want to repeat the experience. This is why he consistently refused to increase debt in the years when Russia could easily access international debt markets and why the country’s sovereign international debt is at only 3% of GDP. This is also a theme he referred to many times during the EU financial crisis and specifically the positions that countries such as Greece and Portugal found themselves in.

## No Challenges to Putin

**It is in the interest of all players to maintain the equilibrium.** The issue for Putin is that he has to balance his senior appointments between different tendencies, because if one of them gains the ascendancy, they may be emboldened to put forward their own candidate for President. There are many in the Russian elite who would like to take Putin’s place, but none of them has the power base to do so, and they would be cut down by their competitors if they become too strong. At the moment it is in the interest of all players to maintain the equilibrium, and the risk for Putin is that he provokes one side into putting forward their own candidate if he leans too much toward the other. The securocracy would be the most likely to impose this sort of Khrushchev-style palace coup, given that they control the mechanisms that would enforce it.

**The obvious potential challengers to Putin are all staunch loyalists.** The most obvious potential challengers to Putin seem unlikely because they are all genuinely viewed as staunch loyalists. So Igor Sechin (President of Rosneft), Sergei Ivanov (Head of the Presidential Administration) and Dmitri Medvedev (Prime Minister), would head the list of alternatives to Putin. These are all people who owe their career to Putin but there are undoubtedly scenarios under which they would challenge for his job, as part of a coalition.

**Khrushchev-style palace coup highly unlikely.** This possibility is highly remote, and would only take place in reaction to some policy mistake, or a real worsening of the situation in the country. The factors that led to Krushchev’s ouster are not visible in Russia today; Krushchev spent a lot of time abroad, creating a space for conspiracies against him. Also, his policies were controversial, especially in agriculture. Contemporary sources attributed his removal to his hostile stance with China, which his colleagues disagreed with. Finally, Krushchev was 70 at the time of his removal, and was ready to retire.

**No challenger has the power base to mount a challenge.** Putin does not delegate his key functions, and so no one is able to establish dominance over one part of the government, which then creates a platform for a challenge to Putin. He also rotates key jobs, which again makes it harder for any one individual to become too entrenched. Shoigu was the longest serving member of the government, before he was moved to Moscow region and then to the Defence Ministry. Similarly with the FSB or the Ministry of Internal Affairs – Putin either only appoints close loyalists, or he rotates the ministry regularly to prevent it becoming captive to any one group.

### Public Support for Putin is Solid

	Jan '13	July '13	Oct '13	Dec '13	Feb '14	May '14	July '14	Sept '14	Oct '14
<b>Vladimir Putin</b>									
<b>Approve</b>	64%	67%	64%	65%	69%	83%	85%	86%	88%
<b>Disapprove</b>	34%	32%	35%	34%	30%	16%	14%	14%	11%

Source: Levada Center



## Status quo between factions

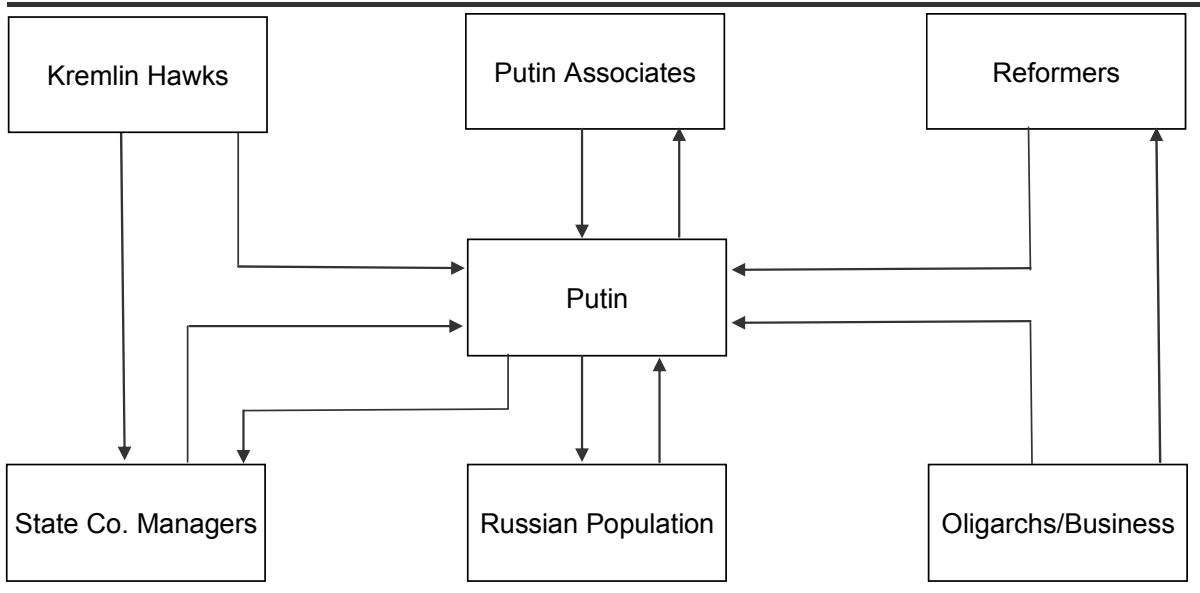
**Russian politics often seen as a battle between reformers and hardliners.** Western commentators have seen Russian politics as a battle between “reformers” and “hardliners” since the middle of the 19<sup>th</sup> century. The problem is that this is really a shorthand for “more like us” versus “less like us”, and this is not always the best frame of reference for analyzing Russia. There is also a tendency to compare Russia to what the West ought to look like, rather than what it actually looks like, let alone the difficulty of defining exactly what “the West” is.

**Any political system is driven by individual ambitions.** Anywhere in the world, individual politicians are happy to sacrifice their personal convictions to personal advancement. This is especially so in Russia where so many senior politicians (or their close relatives) end up rich. This means that political convictions are really a means to personal advancement, so it is not useful to try to read the tea leaves of various politicians to understand their view of the world, and assume that the political success of one individual is due to growing support for those presumed views. The process is much more like that of an investment bank, where individuals jockey for positions near where the money is flowing, rather than an innate preference for a particular line of business.

**No major change in the government since Putin was last elected.** The first two years of Putin’s third term saw frequent rumors that Dmitri Medvedev was about to be sacked as Prime Minister. This was supported by the view that Medvedev was only given the job in order to persuade him not to run for President against Putin. However, there has been no major change in the government since Putin was elected, apart from the sacking of Anatoly Serdyukov, the Minister of Defence, who left under a cloud because of a corruption scandal. None of this affected Medvedev, as the Defence Ministry is a direct presidential appointment. If anything it strengthened him against some of his opponents in the securocracy, as it showed that they had weaknesses too.

**Putin likely to keep his government stable for the time being.** Medvedev’s main problem is that he has failed to deliver on the Presidential program of social guarantees made by Putin during his election campaign. However, given that there is no strong challenger from within the government, and that the failure to deliver is more the result of actions by people that he did not appoint, he has been able to defend his position. One theory was that he would be removed after the Sochi Olympics, in order to clear the way for a new economic policy, but presumably the turmoil in Ukraine has persuaded Putin to keep his government stable for the time being.

**Power Connections**



Source: Macro-Advisory Ltd estimate

## The Bashneft Affair

**Sistema was brought in as a “white knight”.** Bashneft is a large oil company, which was bought by Sistema, a holding company, from companies related to the former President of Bashkortostan, an autonomous republic within the Russian Federation. This deal, closed in 2009, was part of the process of removing the former President of Bashkortostan, Murtaza Rakhimov, from power. This is because Bashneft dominates the republic’s economy, and if Rakhimov had retained control, he would have been able to maintain his influence in the region, and the Kremlin was keen that he should leave. So Sistema was brought in as a “white knight” so that the assets could be parked with an oligarch that the Kremlin saw as loyal. The assets were bought from a company controlled by Rakhimov’s son, who had privatized them.

**Bashneft benefitted greatly from Sistema management.** Sistema did a lot of good work with Bashneft, bringing in a respected oilman, and financing the restructuring of the asset. This involved bringing a number of upstream and downstream companies into one streamlined organization. Bashneft was allowed to win the bidding for the Trebs and Titov field, one of Russia’s most promising, despite Lukoil’s protests that it had been promised them. Bashneft needed Trebs and Titov as its upstream assets were reaching maturity. This again was seen as a sign that Sistema’s purchase of Bashneft was blessed by the Kremlin, as Lukoil also carries significant political weight.

**Sistema sought LSE SPO to entrench its value in Bashneft.** In 2013, Sistema started to let it be known that they planned to place part of their holding in Bashneft on the London Stock Exchange via a secondary placement. This was seen as a good way to increase Bashneft’s liquidity, and to crystallize the value in Sistema’s holding structure, as Sistema has perennially traded at a discount to the market value of its holdings in the listed companies it owns.

**Government investigation into privatization of Bashneft.** Then in April 2014 it was announced that Sistema’s stake in Bashneft would be frozen, as part of an investigation into the privatization of Bashneft. To begin with this was presented as Sistema having inadvertently received stolen goods (i.e. the privatized shares in Bashneft) but as time went by, the pressure directly on Sistema increased, which led to Sistema’s President, Vladimir Yevtushenkov being placed under house arrest.

## Another Yukos affair?

**Oligarchs come under scrutiny again.** This was the first time that an oligarch of this status had been arrested since the incarceration of Mikhail Khodorkovsky, then president of Yukos, in 2003. That was seen as a defining moment in Putin's Presidency, as he struck out against the oligarchs who had supported his election, but increasingly frustrated his policies, particularly in terms of his desire for the wealth from Russia's oil exports to be reinvested in Russia. Since then, the only arrests of senior businessmen seem to have been related to genuine suspicion of wrongdoing, or internecine war within business clans.

**Yevtushenkov is viewed as a neutral oligarch.** Yevtushenkov is an oligarch on the scale of Khodorkovsky, given his control of Bashneft and MTS, one of Russia's largest mobile operators, and other businesses. His rise was linked to the former mayor of Moscow, Yuri Luzhkov, as well as to the Moscow branch of the old KGB, but since Luzhkov's fall from grace he had been thought of a politically neutral oligarch, with no ambitions other than growing his business. Certainly there was no particular scandal associated with him in terms of how he acquired or ran his businesses, and there was no hint that he was in any way in opposition to the Kremlin.

**Rosneft denies interest in Bashneft.** The most prevalent theory on this situation is that pressure is being put on Yevtushenkov to cancel the sale of Bashneft on the LSE, and to sell it to a Russian buyer, most likely Rosneft, or companies close to its management. There are unattributed press reports that talks on this subject took place, and failed because the price offered was insufficient, although Igor Sechin, the President of Rosneft, has denied that he was ever interested in Bashneft.

**A veiled attack on Medvedev?** Another conspiracy theory doing the rounds is that this is a veiled attack on Medvedev, as he was president when the sale of Bashneft to Sistema was approved. This seems more far-fetched, as Putin was prime minister at the time, so the deal was also passed by him, and in any case at the time, it seemed more like Sistema doing a favor to the government, rather than the other way round. The deal was done as part of the process of gaining control of an important autonomous region, and must have been widely approved within the internal security services.

**Ownership of large assets is often quite murky.** There is also the possibility that some other figure wants to participate in the proceeds of the sale of Bashneft. The nature of ownership of large assets is quite murky in Russia, as often oligarchs are only trusted custodians for other people or persons. This was brought out by the Abramovich-Berezovsky trial in London, where it was clear that Berezovsky felt that he effectively owned 50% of Abramovich's assets, even though his name was nowhere near the shareholder register. It may be that some individual feels that they have the same right to Bashneft, rightly or wrongly, and they are using their influence over the criminal justice system to bring Yevtushenkov to the negotiating table.

**Signal in relations between oligarchs and the Kremlin unlikely.** This episode is not viewed as a sign of a major shift in the power relations between the oligarchs and the Kremlin. It is still most likely that the situation will be resolved now that Bashneft has effectively been removed from Sistema. Putin and Sechin have both gone on record as saying they have nothing against Yevtushenkov personally, so it should just be a question of negotiating a civil settlement. The fact that the court date keeps getting postponed suggests that the various sides are negotiating a deal.

## **Electoral Control**

**The Kremlin has greater control of the regions.** The next Duma elections will see half the Duma deputies being elected directly. This is how the system used to be, before it was changed in the first Putin administration, mainly to give United Russia and the other central parties a greater chance to control the Duma. It also gave the Kremlin greater control over who became a deputy. Deputies are immune from prosecution, and for a number of candidates, this was the prime attraction of getting a seat, which meant that a number of undesirables became deputies. The relaxation of this law probably reflects the Kremlin's greater confidence in its control of the regions, especially at the level of the electoral commissions. People with a criminal past and other undesirable elements can simply be weeded out before they can even stand for election.

**Election of Mayors now the accepted norm.** A recent innovation to allow the election of Mayors also seems to be sticking. The ruling elite are not against elections per se, as long as they get the results that they want. This does not automatically mean that the winner should be from the ruling party, United Russia. If a Mayor from another party can get elected despite the superior resources of United Russia, then that implies that he or she has very strong local support, which makes them automatically the person that the central elite wants to deal with.

## **Continual tinkering with regional government**

**Central control to remain.** Russia is going to remain a centrally managed country. Each Governor rules with Putin's personal approval – the process of their resigning ahead of elections is normally marked by a televised meeting with Putin as a mark of his blessing on them. Although Putin does not handpick every one of the 89 governors, he is on close terms with many of the most important. The KPIs for the governors include delivering votes for Putin at the Presidential election, stopping any protests in their region, facilitating the fulfillment of the plans laid out in Putin's presidential program, and not stealing too much.

**Manual control of the country is complex.** This manual control of the country is complex, and outsiders don't pay enough attention to it. There is a structure of Federal Districts that monitor governors and act as the President's eyes and ears over the governors in their districts. They also talent spot local administrators – Sobyanin, Bastrygin (head of the Investigative Committee), Kozak and Khloponin are all current ministers who first made their mark at a local level. In fact, Putin got his start this way, when he was a deputy Mayor of St Petersburg, and was noticed by Borodin, then head of the Presidential Administration. This means that all local officials are subservient to Moscow, and are concerned about any potential resonance for their actions in the capital. This distinguishes Russia from China, where regional Party Chairmen have a great deal more power, and see successful management of a region as a path to greater things at a national level. The post of Governor in Russia is not a stepping stone in this way, and regional officials only get promoted if they are obedient to Moscow.

### **More vs less local democracy**

**Budget allocations to regions are linked to United Russia votes.** The defining moment for local government was the Beslan siege in 2004. This horrific act of terrorism showed the ineffectiveness of local government and was used by Putin as a reason to abolish the direct election of governors. This then allowed him to put hand-picked individuals in place in the Caucasus, which has helped to make the region much more peaceful. In 2011, while Medvedev was President, the law was changed to require direct election of governors, which was partly designed to increase local legitimacy, and partly a way to test whether governors actually had control over their local electorates. It is worth noticing that central budget allocations to regions are positively correlated with the vote gained by United Russia in the most recent Duma elections, another sign that the primary task of a governor is to deliver votes for the ruling elite when it counts.



## What Drives Foreign Policy?

*"Domestic policy can only defeat us; foreign policy can kill us"*

John F. Kennedy

**Border security and trade.** The key goals for Russia in external affairs are first to secure its own borders, and second to enable trade. It is also important for Russia to feel that its opinion is respected. This leads to Putin's strategic goal of making the world more multilateral, as Russia's UN veto becomes more important in this scenario, and the Kremlin hopes it can play China off against the US.

**Tactical input from Lavrov.** The Russian Ministry of Foreign Affairs has traditionally been subservient to its political masters in Moscow, but Sergei Lavrov's ascent to the position seems to have increased the Ministry's influence. Foreign Ministry fingerprints are visible on Putin's tactical success last year in relation to Syria, where he got the US to agree not to bomb Syria if Syria surrendered its chemical weapons, and then got Syria to surrender those weapons. Putin is willing to delegate to those whom he trusts, and the Foreign Ministry has been able to execute in complex diplomatic situations like those around Syria and Iran, and so he has given them more of the work.

**Strategic motivation.** The main strategic issue for Russia currently, though, is Ukraine, and here Putin has been setting the agenda directly. Ukraine is important not just because of its geopolitical position between Russia and Europe, but it also impacts key domestic issues like defence (because of the assets in Crimea), trade, and also Putin's relations with his own state and private sector oligarchs.

**Historic policy towards Ukraine.** Putin's blueprint for his ideal relationship with Ukraine is that with Belarus. He sees this country as a slightly more independent region of Russia, just a little bit more free than, say, Chechnya or Tatarstan. In return for subsidized gas and oil, and access to Russian markets, Putin asks for a cooperative defence policy, support in foreign affairs, and a subservient attitude towards Russian language and culture. Putin is willing to offer quite attractive terms for this sort of behavior, and these were on offer to Ukraine.

### Secure borders

**NATO is seen as a purely anti-Russian organization.** You really have to be sitting in Russia to understand why the Russians are so annoyed about the persistence of NATO. It was created to deal with the specific threat of the Soviet bloc, and in response to Soviet expansionism that was driven by ideology. This ideology was abandoned during the 80s, along with Communism. Now NATO seems to exist as a purely anti-Russian organization, and it appears to have the aim of increasing its membership. It doesn't seem to have a remit outside Europe, it has large overlaps with more multilateral bodies that also deal with European security, and seems to act as an American spearhead. It probably shouldn't exist at all, but like all international organizations, it seems to acquire a bureaucratic logic of its own that resists all attempts to reform it.

**Anger at NATO expansion east.** This is why the Russians get so upset when they see NATO expanding towards it. There was no major resistance to the accession of the Baltic states and the former Warsaw Pact countries, because these countries could point to recent history and the need for protection. However, Ukraine has looked to Russia for protection for much longer, and cannot really claim to be a nation that was heavily oppressed by the Soviet Union, given that much of its territory is historically Russian, given to it by Lenin.

**Russia has given more economic support to Ukraine than has the West.** It is also important to understand that Russia has given a lot of economic support to Ukraine, much more than the West has done. If Ukraine were to join NATO within the current status quo, Russia would perceive itself as subsidizing Ukraine's membership of a body that is fundamentally hostile to Russia. Ukraine's current economic woes show how badly the country fares when it is cut off from Russian support. Russia is happy to give that support, but wants cooperation in return.

## **Economic**

**Ukrainian had multiple opportunities to normalize the gas trade with Russia.** Russia's primary economic interest in Ukraine is the gas trade with Europe. The difference with Belarus is that the rents from the gas pipeline in Ukraine have mostly been appropriated by various private commercial interests, whereas Belarus has used these rents to support Lukashenko's authoritarian government. The Ukrainians have had multiple opportunities to normalize the gas trade with Russia, but have chosen not to do so. The rents from their gas pipeline could have been used to modernize the economy and to wean them off Russian gas, but this has not been done.

**Ukraine needs to clean up its house.** No doubt there are also Russian individuals who have shared in the rents that were siphoned off by the Ukrainian oligarchs, and Putin chose to turn a blind eye to this. Nonetheless, if the Ukrainians had cleaned up their own house, the Russians would not have resisted this – they are quite happy to deal with European state bodies on normal terms. Their preferred solution would be for the Ukrainians to sell them the pipeline, but successive Ukrainian administrations have chosen to keep the current muddy arrangements. The Russians go along with this, but they do not see why they have to subsidize the consequences.

## **Oil and Gas trade (% of revenue)**

**Gas transit dominates relations with Ukraine.** Relations between Russia and Ukraine have always been dominated by gas transit. It was notable that when he resigned from the Prime Ministership, Viktor Chernomyrdin, who ran the Russian government during most of the Yeltsin era, became ambassador to Ukraine. This acceptance of a post way below the status normally accorded to officials of his rank is a signal of the importance of the ambassadorship, and of relations with Ukraine. Gas exports via Ukraine make up about 30% of Gazprom's revenue, and Gazprom's taxes are about 20% of the Russian government's revenue. Gazprom's cash flow is important because its capex budget is one of the ways that Putin rewards his associates, both inside and outside the gas sector. Add to that the fact that the subsidies to the Ukrainian economy via the gas price are the main way that Russia exerts influence over its neighbor.

## Customs Committee is very important

**Opposition to Ukraine-EU agreement is surprising.** It is notable that Putin has been very opposed to Ukraine's signing an association agreement with the European Union. This is surprising, as it is a loose statement of intent, which should have no strategic implications. Putin has said that the problem is that the EU has different standards from Russia, so that would complicate trade arrangements with Ukraine, which will gradually harmonize with the EU. But Russia trades with all the other EU and EU associated states without any problems, and it is hard to see why this is the main issue.

**The resistance might be due to two factors.** Gas is normally uppermost in Putin's mind when he thinks about Ukraine's trade relations. Ukraine has already joined the European Energy Union, which is more about harmonizing standards. EU law requires equal access to pipelines, something that presumably Russia would welcome in regard to Ukraine's pipelines. They might have a problem with the fact that Gazprom would not be allowed to use more than 50% of Ukraine's pipeline capacity under EU law, as Gazprom currently uses most of it. However, they could seek the same exemption that they are seeking for Germany's OPAL pipeline. This exemption should presumably be forthcoming, as it is in Germany's interest that the pipeline is filled, and there are no other alternatives to Gazprom.

**Customs Committee maybe resisting Ukrainian accession.** This body is low profile, but it is very important in Russia as it processes huge cash flows, and is widely believed to be close to the FSB. It may be that the Customs Committee does not want to lose control of trade in Ukraine, given that it has a border with Russia, and could act as a back door for European exports into Russia.

## What Drives Internal Policy?

*"The formula 'Two and two make five' is not without its attractions"*

Alexander Pushkin

**Stability.** For an observer inside Russia, it is striking how much the official rhetoric emphasizes that the main achievement of Putin's administration has been the stability it offered Russia after the Yeltsin years. Like any good politician, Putin emphasizes that Russia was a mess when he took over. The official news shows footage of violent anti-government demonstrations all over the world, with the subtext that Russia has been spared these. This is particularly so with Ukraine – ever since the Orange Revolution, Russian media has emphasized the problems that democracy created for the country, in terms of unrest, uncertain elections, and fights and deadlock in Parliament.

**Living standards short of target for 2012 ...** Putin's original core promise, though, was in terms of living standards – the stated target was that Russian GDP per head would beat Portugal's 'within 12 years'. As 2012, approached, there was a lot of debate about exactly when this 12 years started, but the fact is that as of 2013, Russia's nominal GDP per capita is US\$14,500, and Portugal's is US\$20,995, according to the IMF. Things are a bit better on a PPP basis: Russia has US\$24,298 per capita and Portugal has US\$25,643.

**... but progress is still better than expected.** This promise is not much talked about these days, for obvious reasons. But it is worth remembering that Russia has got a lot closer than anyone would have predicted at that time. Especially given that they have done so while eliminating the budget deficit and repaying all the state debt, both of which would have been seen as far-fetched promises, if Putin had made them at the start of his Presidency. But it is worth noting this, because one of the reasons why many Crimeans voted to join Russia, and why many in eastern Ukraine would like to join Russia, is that living standards are much higher than in Ukraine. Ukrainian nominal GDP per head is US\$3,930 and PPP-adjusted the number is US\$8,651 (*both figures from the IMF*).

**Not an issue as long as oil is above US\$90 or so.** The main credit for the boost in Russian living standards of course is because of the higher oil price. It is worth noting that one of the reasons for the big difference between nominal and PPP GDP per capita in Ukraine is the historic cheap energy prices, which were of course subsidized by Russia. There is a similar difference in Belarus. Under the IMF led bailout plan for Ukraine these cheap energy subsidies have to be eliminated.

**Any need of austerity a long way off.** If oil were to trade around the US\$90 p/bbl level the government has no problems in keeping its spending promises, and in dealing with unrest that stems from economic issues. At an US\$80 p/bbl average, this becomes more expensive but manageable, especially as the weaker ruble compensates the budget for the lower oil price. At a lower average oil price, the situation is certainly more complicated. Historically, Putin has been very quick to satisfy the demands of protestors who have a purely economic grievance – for instance in the case of pensioners who were angry about higher prescription charges in 2005 (<http://www.nytimes.com/2005/01/16/international/europe/16moscow.htm>) and laid-off cement workers in 2009 (<http://www.theotherrussia.org/2009/05/21/desperate-residents-seize-town-hall-in-russian-town/>).

The budget can afford to borrow, and indeed, a larger supply of government paper might actually help the interbank market, and even if deficit spending is not enough, there is plenty of fat to be cut in the defence budget if there is not enough money for pensions. There are a lot of economic problems in Russia, but the budget is a long way from the point where austerity might start to cause mass unrest.

**Drives inflation of government salaries (25% of the workforce).** Another factor for stability is that Putin has increased the number of workers employed by the State. This was not one of his goals, but was the natural consequence of his more centralizing authoritarian policies. This is probably storing up problems for the long run, but in the short term, it acts as a political buffer. State salaries have more than kept pace with inflation, so this large part of the workforce is happy with their economic situation. Also, it is standard practice in Russia for state employees to vote in accordance with their bosses' orders, so this creates a large natural electorate for the status quo.

## Opposition movement

**Widespread support for both Putin and the government.** There is an opposition movement in Russia, but it has been suppressed. However, the polls that show widespread support for both Putin and the government suggest that those supporting a change are in the minority. The protests that followed the Duma elections of 2011 were largely made up of younger more educated people in the large cities. Moscow is by far the most anti-government city in Russia, but even here the protest vote is at best 25%.

**Putin plays a balancing act with the opposition.** The President allows his law enforcement bodies to harass them, but has stopped short of outright persecution. For instance, the Investigative Committee used heavy-handed tactics to press criminal charges against Alexei Navalny, the main opposition leader, but his sentence was suspended.

**Intimidation used to quell opposition.** The tactic is to use the threat of persecution to intimidate the opposition. They are allowed to hold demonstrations to blow off steam, again with the threat of violence used to deter participants. The main strategy is to allow some protests, to maintain a semblance of freedom, but to strike hard if there is any suggestion that the demonstrations might turn into the Maidan-style permanent protests that have brought down two Ukrainian governments. One of the reasons why Russia stopped supporting Yanukovich was because it was clear that he was incapable of managing the protests, veering between too soft an approach to begin with and too violent an approach later on.

## Economic goals

The key longer term goals were set out in the Executive Orders of 7 May, 2012, which were intended to set a work program for the government for Putin's second term. The decrees covered:

- Long-term State Economic Policy
- Social Policy
- Healthcare
- Science and Education
- Housing
- Public Administration
- Interethnic Unity
- Military reform and spending
- Demographic Policy

These documents are important as they set specific quantities and deadlines to be spent on these policies, and Putin intended them as a yardstick to measure the work of his government.

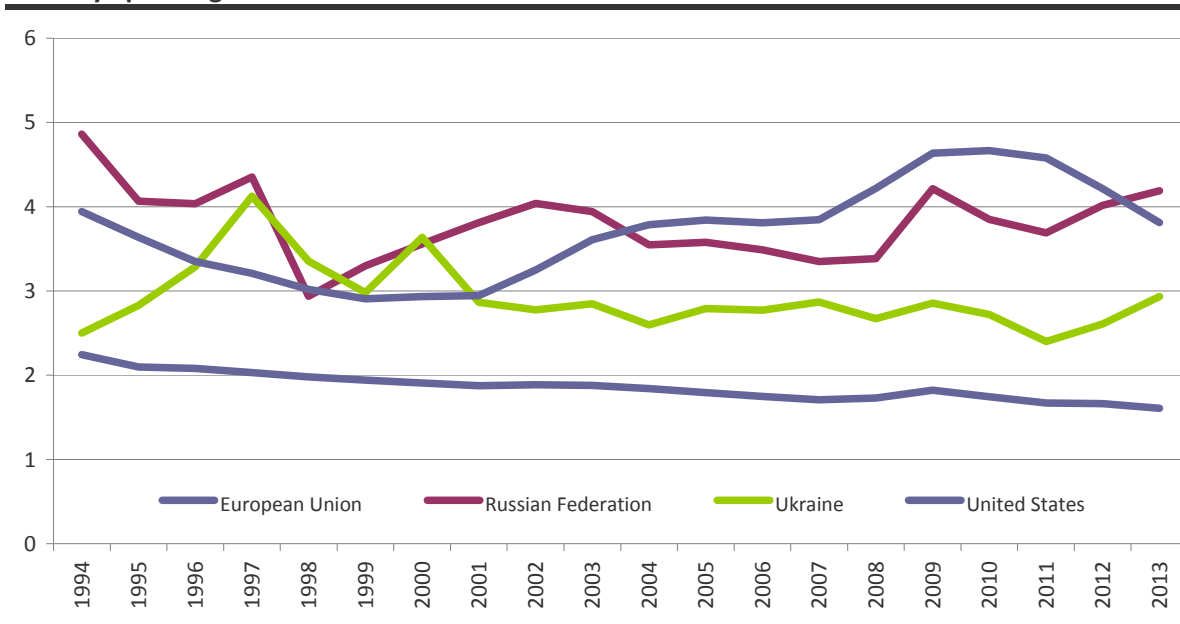
**Putin is impatient with slow implementation.** A government meeting on 7 May, 2013 to review progress on implementing these orders saw unusually harsh public criticism of his government by Putin, and led to the resignation of Deputy Prime Minister Vladislav Surkov, a key political operative of Putin's. This was designed to send a message to the cabinet that Putin was serious in his dissatisfaction, although not to the extent of firing Medvedev and the whole cabinet. The symbolic nature of this firing was shown by the fact that Surkov reappeared soon after as Putin's main coordinator for the Southern Caucasus, and some press reports have suggested that he was the main Kremlin handler for operations in Crimea and eastern Ukraine. There was no equivalent meeting in 2014, perhaps because the issue was overshadowed by events in Ukraine. There was instead a marathon press conference on 7 May, 2014, mainly covering Ukraine.

## Major issues of 2015 budget debate

**Defence spending.** The main headline number of the 2015 budget was a 21% increase in defence spending. This was the subject of intensive preparation – Putin unusually spent an entire week in May discussing it in Sochi with Shoigu, the Minister of Defence, and Rogozin, the Deputy Prime Minister in charge of the military-industrial complex. Partly this was due to Ukraine, but the Defence Budget has assumed increased importance in Putin's third Presidency. There have been significant personnel reshuffles around it, which suggests that a fair amount of corruption has been found, some of which has been made public (for instance, the public firing of Serdyukov, Shoigu's predecessor). This does not imply that Russia will suddenly become expansionist, but it will be more willing to deploy its military when it feels its interests are threatened.



**Military Spending as a % of GDP**



Source: World Bank

**Retain Freedom of Maneuver.** Despite the expansionary defence budget, borrowing will stay within conservative limits. It is not so much that Putin has decided to spend more on the military, it is that he now feels that he can spend more, given that the state finances are in reasonable shape. However, that assumption was based on oil averaging US\$100 per barrel and assumed a budget deficit of less than 1% of GDP. Now that oil has fallen sharply, albeit so too has the ruble's exchange rate against the US dollar (it was assumed at 37.70 in the draft budget), there is again pressure from the Finance Ministry to change spending plans.

**No State Debt.** State borrowing will be kept at a minimum, particularly external borrowing. There has been no hint that government debt will be affected by sanctions, and this is a drastic step that would only be taken in extremes, given that it can take a long time for sanctions to be unraveled. Russia will continue to borrow in order to maintain itself on the radar screens of global bond investors, and there will be new issues to ensure that investors have a good range of maturities to choose from. But a large scale foreign borrowing program is neither planned nor needed.

**Federal Budget for 2013 - 2017 \*\*\***

	2013*	2014E **	2015E	2016E	2017E
Revenues, US\$ bln	\$408	\$395	\$399	\$406	\$416
Spending, US\$ bln	\$418	\$393	\$411	\$419	\$430
Balance, US\$ bln	\$10	\$2	-\$11	-\$13	-\$14
% of GDP	-0.5%	0.1%	-0.6%	-0.6%	-0.6%
Urals Price, US\$ p/bbl	\$108	\$103	\$100	\$100	\$100
RUB/US\$1, average rate	32.30	36.10	37.70	38.70	39.50

Source: Finance Ministry

\* actual result

\*\* Macro-Advisory forecast

\*\*\* Finance Ministry plan

## Some moves on infrastructure

**Stagnation evident for more than more than 18 months.** The first signs of stagnation were seen in early 2013, when investment started to fall in absolute terms. This would have been the perfect time for the government to execute a classic Keynesian maneuver to boost public sector investment to compensate for the weaker optimism of the private sector. There was some debate about this, and the government even debated specific projects, but Putin decided not to move forward with, say, large-scale rail projects, because he was not convinced that they were needed.

**US\$50 billion spent on Sochi Olympics.** One public sector investment project that was implemented was the Olympics in Sochi and the surrounding infrastructure, but currently this seems to be more white elephant than public infrastructure. An estimated US\$50 billion was spent on the project, and while Sochi has acquired a world-class transport infrastructure and sports facilities, it is not clear that Russia will be able to attract the sort of tourism that will justify this economically. Creating a gambling center in the city will help but the

**The 2015 budget does envisage a boost to infrastructure spending.** Some US\$13 billion, including spending on railways to bypass Ukraine, presumably providing direct links with Crimea (which will compete with Sochi for tourists), and also via Belarus to Europe, has been earmarked for 2015. This is about 0.5% of GDP, and more was hoped for. It is surprising that more action has not been taken on this front – there is no shortage of money to pay for this sort of demand stimulation, and Putin has listened to his economic advisors in the past. Conversations with the Ministry of Finance have suggested that there is some concern that demand stimulation might be inflationary, especially given that there is full employment. Inflation is certainly a problem, but this is more a question of a lack of competition than too much demand.

## 2012 Promises to Electorate

**Expensive promises at last election.** Putin's promises to the electorate were quite generous, but then, at the time the economy was doing well and oil was strong, so they seemed quite realistic. It is questionable whether anyone took any notice of them at the time given that Putin's popularity and political machine assured him victory in any case. It is noteworthy that Putin seems to take them seriously and wants to be able to come back to the electorate in 2018 with a declaration of mission accomplished.

**Laws expected to implement them.** Putin criticized his government in 2013 for failing to draft many of the legal amendments needed to implement his electoral program. Much of the government's legislative program is expected to cover these issues going forward. These should cover pensions, mechanisms for control of regional budget allocations, building permits, and programs for small businesses. In general, money was allocated, but government inertia led to programs being stalled. Once things have calmed down in Ukraine, we can expect another high level meeting to discuss these issues, and it is probable that Putin will give his government another dressing-down.

## How Russian Legislation Works

*“Writing laws is easy, but governing is difficult.”*

Leo Tolstoy, War & Peace

This section will use case studies to give a flavor of how legislation gets to the Duma, and what processes it goes through once the first draft becomes public. The most important point here is that when a first draft is announced in the Duma, this is generally the start of negotiations about its contents, not a final statement of policy by the government. This is particularly important to remember given the number of potentially damaging draft bills proposed by Duma deputies since the Ukraine crisis started.

**The press tends to announce first drafts as a fait accompli.** The fact is that even if the cabinet has signed off on a piece of legislation to be submitted to the Duma, various ministries will continue to lobby the Duma for changes that they were unable to get supported in government. We will give some examples of how quite tough legislation gets watered down in the Duma. The process seems to be that senior ministries get to fight off attempts to change their legislation while it is going through the government, so most of the lobbying is done in the Duma.

### Housekeeping for technical issues

**Laws enacted to facilitate efficiency.** These are the sorts of law that any government needs in order to run efficiently – often for instance technological advances mean that legislation needs to be brought in line with a changed reality. An example of this is the recent new rules requiring those with dual citizenship to notify the government. This was not an issue before as the Russian government did not formally permit its citizens to have more than one citizenship in the absence of a dual citizenship treaty with the country in question. However, as more and more Russians have travelled and temporarily emigrated, this has become a bigger issue, and the government turned a blind eye to it, especially where the country does not allow for citizenship to be formally renounced.

**Now the state can check.** What seems to have happened was that the Federal Migration Service (FMS) was tasked with providing data on the number of individuals with dual citizenship, and was unable to do so, because it does not have access to data on foreign citizenship. So the law was introduced, and within about 3 months the requirement was enacted. This was partly in response to a situation that did not exist ten years ago when much of the current legislation was enacted. Presumably it is being enacted in relation to various questions being raised about senior government officials having citizenship or residency rights in other countries. This is forbidden by other laws, but until this new rule came in, the state had no way of checking on this.

## Headline grabbers to keep the Duma quiescent

**Media ownership ...** The best example of this is the recent law stopping foreign ownership of major media outlets. Like any public politicians, the Duma would love to be able to control what the press says about them, and they have been pushing for this sort of a law for a long time. The first time this was debated was when Berezovsky owned Russia's Channel One, the main TV channel, and there were fears that when he fell from grace he might use this as a platform to attack the government from abroad. This was brought back into the state fold, and the general policy was that foreigners could not own mass market TV channels, especially those that broadcast news.

**... it was thought an equilibrium had been reached.** This situation was thought to have reached an equilibrium, where if a media outlet had foreign ownership, this was because a Russian oligarch preferred to hold his share in it via an offshore company, or the media was politically neutral (like the CTC entertainment channel which broadcasts no news or documentaries) or insignificant, like *No-vaya Gazeta*, the main opposition newspaper, or politically unimportant magazines like lifestyle or entertainment titles. The foreign owners of these media have been caught between the generally greater vigilance over potential foreign influence following the unrest in Ukraine on one side, and by various Russian media oligarchs wanting to capture a bigger share of the advertising market on the other. At a time when pro-Kremlin oligarchs are suffering economically because of their proximity to power, it is easy to give them some sort of compensation by giving them an advantage over their foreign owned competition.

**Deputies benefit when they vote in favor of an individual's interests.** So here there is a mix of political expedience (although the changes do not significantly affect the Kremlin's control of the air-waves) and of special interest lobbying finding a receptive audience in the Duma. Duma members benefit materially when they vote in favor of an individual's interests, and there will also be a quid pro quo from the Kremlin in return for their support.

## Not everything sails plainly through the Duma

**The Rotenberg law.** An example of legislation that really only starts to be debated once it gets to the Duma is the law granting compensation to those who lose assets due to sanctions against Russia. This is known locally as the Rotenberg law, as Arkady Rotenberg, a prominent Russian businessman was seen as the main beneficiary. He has denied that he will take up any of the compensation offered to him under the law, but this may be just a negotiating stance (for instance it may not be he who applies, but his companies or sons).

**In any case, the law is controversial.** The Minister of Economic Development, Alexei Ulyukaev has criticized it in the Duma, saying it would encourage capital flight, since it offered an implicit state guarantee on foreign-owned assets. Interestingly at the first reading, 202 out of 450 deputies voted against the bill. Very likely the Communists and Liberal Democratic Party voted against it. The former presumably have ideological grounds, but both may also be setting up a negotiating position to see what benefits they can extract if they switch their vote.

**The ruling party can push this sort of legislation through, but may choose not to.** Although they have significant administrative resources to push through their re-election, they have had a number of setbacks at the polls, and there have even been suggestions that Putin might choose to sponsor another party as the party of government. If so, they might be unwilling to be seen to support a bill that is so plainly pro-oligarch, to avoid criticism from the Communists at the next elections.

## Long Term Challenges for Russia Remain

*“Insanity: doing the same thing over and over again and expecting different results.”*

**Albert Einstein**

Although Putin has been successful in stabilizing politics in Russia and in using its mineral wealth to boost living standards, in the longer term this equilibrium is unlikely to be stable. The price of oil is notoriously volatile, subject to a combination of economic, political and “black swan” type events. The price (Brent) had been relatively stable at just under US\$110 per barrel for the past three years, but then plummeted by US\$30 per barrel in a matter of weeks since August. In the very long term, it does seem likely that alternative sources of fuel will reduce the world’s need for oil and gas but it does not seem likely to be a real threat in the next 25 years. And in the meantime, it is entirely possible that one of Russia’s other abundant natural resources (water, for instance) will become equally scarce. As long as this is the case, i.e. that Russia remains an important supplier of raw materials to the rest of the world, the state seems viable.

### Natural Resource Curse

**Diversification is proving difficult.** The Russians know that they have a natural resource curse, and both Putin and Medvedev frequently refer to the need to diversify the economy. At the same time, neither has been very good at implementing changes. Both pop up every couple of years, lamenting the number of permits needed to run a business, implement some cosmetic changes that are meant to reduce the number of inspections, the government ignores these, and the administrative burden on business carries on rising. This has been going on since 2001, and seems unlikely to change.

**Attempts to diversify ineffective.** Programs like the Skolkovo business school and innovation cluster, and “Moscow as an international financial centre” really only serve to show the ineffectiveness in these matters. Strong financial markets and innovation clusters are the result of successful policies, not the cause of them. The problem is that there is no urgency for government to do anything as long as it gets its money from natural resources, and it can use this cash to ensure full employment.

**Distribution of natural resource rents dominates.** As long as Russia’s economy is dominated by natural resource rents, then it seems likely that the political system will also remain focused on distributing those rents, rather than ensuring the protection of individual property rights that seems to underlie the economic success of the liberal democracies.

**Property rights needs to be prioritized.** One scenario is that the businessmen who used their political connections to acquire assets under the current regime will use those connections to protect their property rights and the system will reform in this way. The best example of this is the US robber barons of the late 19<sup>th</sup> century, who abused the law to build their empires and then strengthened the law to protect them. However, the counter-example is that the first generation of businessmen in post-Communist Russia has not been particularly active in establishing a system to protect their property rights or anyone else’s. Rather, they have tended to support the status quo.



## Demographics

**Life expectancy improves.** There has been a lot of comment in recent weeks that the average life expectancy in Russia has finally made it above 70. This is more due to economic growth and the importing of better medical care from abroad than due to any particular efforts of the government in this direction. Putin has been adamant in resisting calls to raise the retirement age from 55 for women and 60 for men, citing the short life expectancy, and also because he does not want to alienate this key part of the electorate, who might otherwise vote Communist.

**Demographic situation shows improvement.** Russia's larger demographic problem stems from the low birth rate in the 1970s and 1980s, during the worst of the Soviet era when poor living standards and a lack of housing made having more than one child uncomfortable. Current better living standards mean that the birth rate is now finally higher than the death rate, but Russia has a labor shortage and will continue to do so for at least a decade. This shortfall has been filled by labor migration from the former Soviet states, especially Central Asia. There has actually been a demographic windfall from the troubles in Ukraine as hundreds of thousands of refugees have sought shelter in Russia and have been relocated to areas that need more population, as far east as Vladivostok. According to Putin, in 2013 alone almost 3 million Ukrainians found work in Russia. He claimed that their earnings in Russia totaled over US\$20 billion, which is about 12% of Ukraine's GDP. But this is not a lasting solution.

**Incentives in question due to budget cuts.** Current policy is to provide large material incentives, including bonus payments for a second child, and special support programs for more than three children. These programs are threatened by budget cuts, although the Health Minister, Elena Golodets recently announced that they would continue for one year more.

**Gambling on oil receipts.** The government is taking the gamble that oil receipts will be enough to cover pensions through the next fifteen years or so while the working age population is shrinking relative to the retired population. It is doubling down on this gamble by taking the contributions to the savings portion of the pension fund and using them to finance current spending. In a less rich country, this would be foolhardy, but as long as Russia is willing to deploy its oil income in this way, it should be able to muddle through.

## Post-Putin Period

**The biggest long-term unknown is what happens in the post-Putin period.** The President is in good health, but there is always the Black Swan possibility of him no longer in the Kremlin. There is a pool of people around him from which a successor could be found, and the system may well be robust enough to work with a different person at its centre. The risk would be that personal rivalries between the potential successors would work to damage the system.

**An extreme scenario would be de facto civil war via the criminal justice system.** The rivals arrest each other's associates for various trumped up charges like corruption or embezzlement, and then there is a battle for control of the courts. For instance, if pressure is being brought on Yevtushenkov via the courts, that means the Investigative Committee is using its muscle to work on behalf of someone. If the same tactic were to be applied by, say, Sechin against Sergei Ivanov, then we might see some of Ivanov's clients, like Dimitri Rogozin, investigated for corruption of some sort. Ivanov can presumably fight back via the FSB, and then we have a war of the law enforcement agencies.

**The need for an effective arbitrator.** Putin's main role is to act as arbiter between the different groups at the top of government, and without him there, then there is a real fear that the situation could descend into chaos or even violence. With the law enforcement agencies fighting, then there is a real risk that Moscow could lose control of the country. It is assumed that all sides accept that it is not in their interest to have this sort of situation, and some sort of arbiter would be agreed on by both sides, which would replicate the situation with Putin.

**Essentially, the system needs a person like Putin, so it would create one.** This is a fairly natural state of affairs for Russia, going back to the Tsarist period, where the Tsar was the break point between factions in the government, essentially agreed upon by all players. Brezhnev played much the same role in the Soviet Union, and to some extent, Putin himself was created by this process.

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