

Russia

Politics/governance

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The Putin-Medvedev tandem at mid-term

Political risk tilts to the upside as Medvedev heads for a second term

The start of a pre-election year in Russia has intensified speculation about the future of the country's dual leadership or "tandem" as it is often called. A widespread view regards personal ambitions and bureaucratic clan rivalries as likely to destabilize this construct, damaging Russian markets' outperformance potential based on the relative cheapness of present valuations. To assess both this negative risk and the upside political risk stemming from the tandem's potential for positive policy action, we go back to basics: an analysis of the goals and methods of the Putin system of authoritarianism with the consent of the ruled.

Key judgments

- ▣ While still the junior partner in the tandem, Medvedev is now fronting all policy – under the banner of "modernization", which appeals to value-adding elites. Putin meanwhile holds the rear, maintaining stability and popularity by running paternalist social policies.
- ▣ The popularity of the leadership despite economic recession combines with Medvedev's maturing as a leader to strengthen the prospect of continuity. That means a second presidential term for Medvedev, from 2012 to 2018.
- ▣ We see no grounds for expecting political upsets from Russia's top leadership in 2010.
- ▣ Medvedev's political reform initiatives constitute a qualitative advance that could indirectly enhance market outperformance by providing reinforcing arguments for investment strategies focused on Russia's attractive valuations.

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Context

The turn of 2009-10 marks the mid-point in Russia's current political cycle, in which the country is being ruled by the "tandem" of Prime Minister Putin and his protégé, President Medvedev. From now on Russia's political life will be dominated by the prospects for the elections due in December 2011 (parliamentary) and March 2012 (presidential). This turning point has sparked an even heavier-than-usual dose of punditry and forecasts from politicians and political commentators in the Russian media.

The main topic of such discussions is Putin and Medvedev's strategy – joint or competing? – for the presidential election. This is the question which deserves investors' attention. At stake here are the stability and effectiveness of Russia's governance for the next two years at least and probably for the entire new political cycle beginning in 2012.

The impact of Russian political risk in 2010

The importance of political risk for asset prices is self-evident – especially in the case of Russia. But it is important to consider exactly how this risk can play out at the stage the country has now reached.

Political drivers for absolute returns

Russian benchmark indices in 2010 will remain highly dependent on global factors (among which the oil price, while always a powerful driver of short-term sentiment, is less important than overall risk appetite and funds flows). So it is difficult to see any domestic driver having a decisive influence on the overall direction of Russian markets. One possible exception to this rule is a political shock. If the Putin-Medvedev tandem were destabilized (as is now expected by many a Moscow pundit), this could negate the positive effect of the benign external environment of 2009 continuing into 2010.

Political drivers for relative returns

From the point of view of investors who are sceptical about a continuing benign global environment (or who are merely resigned to increased volatility on the back of successive – and contradictory – waves of fear about interest rates being pushed up by reviving inflation and/or fiscal crises, double-dip recessions and so forth), Russian markets' traditional overshooting on the downside would simply be made even worse than usual in the event of a destabilizing power struggle in the Russian leadership.

But could political factors affect relative performance on the upside? The present political mid-term coincides with renewed valuation catch-up potential for Russian assets. This applies in particular to equities, whose consensus 20-25 per cent average discount to EM peers is driven by several effects of the global crisis:

- ❑ The revealed vulnerability of Russia's financial markets to financial (out)flows, reflecting first and foremost weaknesses in the financial sector and financial policies;
- ❑ The deep recession – largely driven by the same financial weaknesses – which has hit balance sheets and earnings;
- ❑ A fresh spike in perennial investor concerns about the rule of law in general and property rights in particular, as the crisis has triggered a rash of corporate governance scandals against the background of

relentless corruption.

Politics will not contribute much to this relative outperformance potential merely by avoiding any shocks. Put another way, there is no upside from Putin and Medvedev maintaining a united front. The positive potential stems rather from any evidence that their policies designed to address the problems listed above are having the desired effect.

Monitoring such evidence is a core focus of our research ([The prospect of improved financial policy](#), [Russia's fiscal stimulus offers a one-year consumer play](#), [Corruption and the crisis](#), [The importance of imprisoning corrupt officials](#)), and we will continue coverage of these and related topics in separate reports on the individual policy areas. In this note, which has a specifically political focus, we confine the analysis of potential positive impacts to reform initiatives in the political sphere itself.

The anatomy of the Putin system

Those initiatives, which boil down to a succession of baby steps aimed at making Russian politics more competitive, have been driven by Medvedev. This has contributed to what has become the most common perspective on present-day Russian politics. According to this view, the liberal Medvedev (together with the small group of senior officials who have benefited from his patronage) struggles to advance a democratic agenda in the teeth of resistance from the authoritarian statist Putin. The latter is backed by swathes of officialdom, especially in the law-enforcement and security agencies (the “siloviki”), and is thought to be waiting only for the end of the present fig-leaf interregnum before pushing aside his protégé and returning to the Kremlin as president for 12 years (a constitutional amendment enacted in 2008 extended the presidential term from four to six years).

We regard this view – together with its many variants based on the same assumptions – as mistaken. Its only correct assumptions are the two obvious realities:

- ▣ The rivalry and conflict of bureaucratic factions will be accentuated in an environment in which power is shared between two leaders, as in the present Russian tandem;
- ▣ Supreme power remains in the hands of Putin.

So, yes – Putin could become president again if he so desired.

But this is where misunderstandings begin about the more fundamental realities lying behind this facade – that is, about the goals and methods of the governing project which Putin has launched and continues to orchestrate.

1. Its goals: Regaining status on a modern-world basis

Starting with the agenda of this project, there is total unanimity between the two leaders. Minute analysis of what they say and do will uncover no substantive differences, and on close inspection even differences of emphasis usually turn out to be more apparent than real. The key elements in this agenda are clearly and repeatedly stated by both men in their frequent set-piece pronouncements. The overall goal is to recover from the Soviet collapse and re-establish what is seen as Russia's rightful great power status alongside the world's most successful countries and on the same footing as those countries – namely, an open society prospering from a market economy under the rule of law and with democratic institutions.

The practical agenda designed to bring about this overarching goal is two-

pronged:

Stabilizing and strengthening the state. During the Putin presidency, this part of the agenda involved defeating challenges to central authority from armed separatists (Chechnya), regional governors (placed under Kremlin control) and foreign powers (viz. the Bush administration and its supporters in the EU, who were perceived to be bent on diluting Russia's sovereignty and reducing the country to a client state of the "West" by promoting Western-backed political forces throughout the FSU under slogans of democracy).

Economic growth. The legitimacy and stability of the new post-Soviet order are becoming entrenched through the improvement in living standards resulting from rising real incomes, the reduction in poverty and stronger social safety nets created by the redistribution of increased budget revenues. This effect is often contrasted by the present Russian leadership with the dislocation and hardship experienced by the Russian people in the 1990s, when the economy lost half its recorded output and the new institutions were dysfunctional or non-existent. As a result, democracy and the market became dirty words.

The policy content of this twin agenda has naturally evolved over time.

In the "stable and strong state" part of the agenda, Putin was proclaiming a new flagship policy of "administrative reform" by the end of his first presidential term in 2004. This vague and misleading phrase was applied to various policy initiatives; but the underlying theme was the challenge to state effectiveness – not to mention the burden on society and the economy – coming from the state itself in the shape of its own bloated, obstructive and, above all, deeply corrupt bureaucracy.

As for the economy, the key to maximizing the sustainable rate of potential GDP growth came to be seen during Putin's second term as reducing dependence on the extraction and export of minerals with minimal value added by means of intense investment in human resources, physical infrastructure and diversified areas of comparative advantage – all of which would boost total factor productivity.

By the time Putin handed the presidency over to Medvedev in 2008, that economic agenda had been billed as the "2020 Strategy". In what emerged as a clearly planned division of labour between the two men, Putin would concentrate on realizing that strategy in his new position as prime minister while allowing Medvedev, as his junior partner in the leadership, to spearhead a fresh drive to strengthen the judiciary and the rule of law and to combat the state mafia. This reflects the publicly admitted reality that, far from being constrained by the existing "administrative reform" efforts, corruption had worsened. Critics were quick to point out another reality passed over in silence in Putin's and Medvedev's speeches – namely, that anti-corruption campaigns had poor prospects when so many officials at the highest level were themselves corrupt.

2. Its methods: Authoritarian – but with the consent of the ruled

Identifying this division of labour between Putin and Medvedev takes us from the goals of Russia's governing project to its methods. The instrument developed by Putin for implementing this agenda is a unified ruling establishment. Unity, cohesion and effectiveness are ensured by various means. First and foremost, of course, comes Putin's supreme leadership – a key mechanism of which is his creation of a political party (United Russia [UR]) with absolute majorities in the federal and regional legislatures.

Those majorities are not the product of election rigging. To the (considerable)

extent that Russian elections fall short of being free and fair, such abuses – systematic media and bureaucratic bias against opposition parties and, as in the October 2009 Moscow City Duma election, occasional falsification of actual vote counts – merely widen the official margin of UR victories which would have been achieved in any case on the basis of genuine popular support. That support stems from the popularity of Putin himself, as the leader who can plausibly take credit for national recovery, and above all from a sharp improvement in living standards.

So the popularity of the leadership is an essential instrument of Russia's present regime. Since this popularity stems from a perception among most voters that under Putin – now joined by Medvedev – the country is heading in the right direction with tangible benefits for ordinary people (even though the public has no illusions about the modesty of such benefits compared with the rents creamed off by the bosses), it follows that governance in today's Russia amounts to authoritarianism with the consent of the ruled.

This approach to governance is founded on the idea of stability as the indispensable foundation for correcting, by gradual and methodical steps over two or more decades –eschewing radical “big bang” or “shock therapy” measures – the country's mis-development under Soviet communism and central planning. The approach explicitly echoes the political philosophy of Pyotr Stolypin, the effective pre-revolutionary reformist Prime Minister who said shortly before his assassination in 1911: “Give the country 20 years of peace and quiet, both domestic and international, and today's Russia will be unrecognizable.”

Putin's present-day application of this idea envisages a stable ruling establishment presiding over the trappings of a multiparty system undisturbed in practice by political competition because of public support for the leadership. That popularity is channelled into the “big tent” party (UR), which embraces most of the bureaucratic, business and cultural elites in a patriotic project of national recovery.

But the effectiveness of this ruling establishment in pursuing the ambitious goals described above depends on its stability being of the dynamic rather than the stagnant variety. Hence the practice of rotating senior personnel and bringing in fresh faces to regional governorships, top judicial appointments and federal government ministries. This practice has not only intensified under Medvedev but is also exemplified by the Medvedev presidency itself. Because the stable functioning of institutions as laid down in the constitution required the election of a new president in March 2008, Putin presented to the voters for their (inevitable) approval a replacement president in the person of the young St Petersburg lawyer (click [here](#) for our pre-election profile of Medvedev).

Medvedev's role in the tandem

This brings us back to the starting point of our discussion on the methods of the Putin governing project – namely, the division of labour under the dual leadership which came into being in 2008. With the passage of time and, more particularly, under the influence of the crisis, there has been a shift in the initial arrangement, which, as described above, had Putin concentrating on the main economic and social front with the smaller but crucial niche of the rule of law and corruption reserved for Medvedev. There are two aspects to this shift.

1. Medvedev and the modernization campaign

First, in a series of ringing declarations, Medvedev has taken to articulating the whole agenda – including its economic part – and providing “presidential” strategic direction. In essence, he has updated Putin’s original “2020 Strategy”, adding striking rhetoric to the effect that for all the achievements of the past decade the crisis has laid bare how deep Russia’s problems remain. What is now established as Medvedev’s programme carries the one-word title of “Modernization”. Behind this redecorated facade, the basis of the division of labour is shifting from policy areas to a more functional distinction whereby Putin holds the rear with Medvedev in the front line.

Holding the “rear” means maintaining social stability and welfare through the crisis and thereby underpinning the leadership’s popularity – hence the ruling establishment’s hold on power. Commanding the “front line” means the promotion of economic diversification in higher value-added sectors: Medvedev’s five chosen targets are pharmaceuticals and medical equipment, energy efficiency, nuclear energy, telecoms (especially satellites) and IT (especially programming and software development).

2. Medvedev differentiated by political reform initiatives

The other change in Medvedev’s role is connected with the modernization push. He has expanded the corruption and rule of law area to include straightforward political reform in the sense of facilitating increased political competition. The sceptical view of the liberal intelligentsia towards this latest reform drive in response to the crisis (and, for that matter, towards all the Russian leadership’s reform policies) holds that all such initiatives are vain unless the regime permits full democracy. At the rhetorical level, Medvedev’s statements now accept that premise – with the proviso that progress towards this goal must be careful and steady.

Most interesting of all is Medvedev’s publicly stated twofold rationale for his practical political reform agenda. Greater openness and political competition are presented as essential not only for reducing corruption but also for retaining Russia’s best scientists and innovators, who, along with the wider value-adding elite, are vital for the success of “modernization” and who will be more inclined to emigrate from a tightly controlled social and political environment. The same applies more strongly still to the prospects of attracting R&D specialists in the Russian diaspora back to the Motherland.

As for the substance of these political reforms, they comprise a series of small steps. The programme began in late 2008 with rule changes to make it easier for small political parties to win seats in the federal parliament (State Duma) and for all parliamentary parties to get media coverage. In his latest state-of-the-nation address (November 2009) Medvedev extended this programme to the regions (where the worst abuses occur). More important, his latest proposals seek to defend basic legitimacy, hence stability, by targeting some of the most typical forms of electoral rigging. He has ordered a “clean-up” in the practices of home voting and allowing voters to vote in polling stations of their choice (a favourite means of stuffing ballots) and has given instructions that votes should be counted electronically with instant disclosure of the results in each polling station (although this last measure could end up replacing one form of abuse with another).

Even in the aggregate, such steps are a far cry from the instant realization of European-style democracy which for many of Russia’s typically utopian intellectuals is the test of approval. The more serious test than approval in

polite society will of course be whether the ruling group in Russia is prepared to accept the ends, and not just the means, of greater political competition – that is, the possibility of power being won by people or groups not to the taste of the incumbent leadership.

The ruling establishment will not be subjected to this test before the end of the next political cycle – in 2017-18. For now the leadership and UR (which, incidentally, adopted new rules in November 2009 introducing internal “primary” ballots to select election candidates and forcing those candidates to take part in television debates with their opponents during election campaigns) can be relaxed about winning elections conducted on a fairer basis than before. For example, in last autumn’s notorious Moscow City Duma election, exit poll data suggested that UR’s true vote share was a little below 50 per cent – still enough to control the city government – whereas the official score was 66 per cent.

In his political reform initiatives, Medvedev is developing Putin’s agenda in a way which amounts to a step change. Putin created the trappings of a multiparty democracy but failed to pour much substance into that vessel. One does not have to read too deeply between the lines of Putin’s speeches to understand his concerns: partly Western meddling, but mainly the vulnerability of a politically immature society to dangerous demagogues whose ideas would derail Russia’s recovery. Contrast this with Medvedev’s recent statements:

Our political system must be consistent with the interests, convictions, tastes and level of political culture of intellectually independent, enterprising, socially effective and talented people ... (Speech to the UR Party Congress on 21 November 2009)

Modernizing our economy is impossible without structural changes in our society ... including changes to our political culture ... Our society is sufficiently mature for this – still not fully mature, but sufficiently mature: this reality must be borne in mind. (Address to regional legislators on 28 December 2009)

Conclusions

This analysis of the Putin-Medvedev tandem from the perspective of the fundamental political realities that have taken shape in Russia over the past decade provides the best basis for judging political risk – centred on the prospects of the tandem itself – as the present political cycle moves towards its climax in the elections of December 2011 and March 2012.

The great lesson of the previous cycle is to listen to what Putin says. During the long years in which he insisted that he would leave the presidency in 2008, he was generally regarded as being insincere or at least unrealistic. But, as events proved, he meant what he said. This time round, he is saying that he and Medvedev will decide between them what to do about the 2012 presidential election closer to the time.

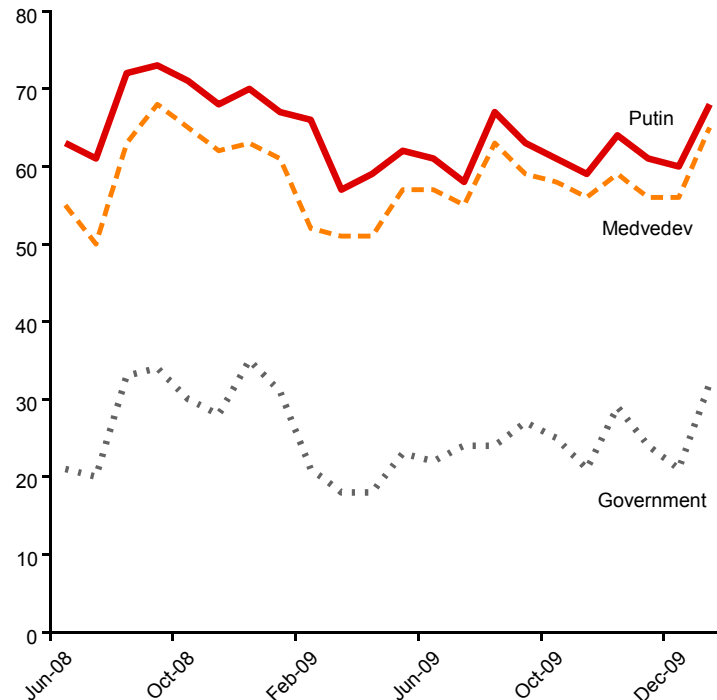
Putin has also indicated the criteria for this future decision – above all, how successfully the present leadership is perceived by the public to have coped with the economic crisis. The other key criterion is left unspoken – namely, Medvedev's own performance or, put another way, how well Medvedev grows into the job of becoming an authoritative national leader in his own right.

Putin's underlying principle is that personal ambition cannot trump the paramount consideration of stability, which is equated with the ruling establishment's hold on power. The logic of this position is that if those criteria have clearly not been met as the next election season approaches and Medvedev needs to be replaced as president with a more credible figure, the successor might not necessarily be Putin himself. For example, any decline in the leadership's popularity would affect Putin as well as Medvedev. As in 1999, when the by then highly unpopular Yeltsin administration selected the unknown Vladimir Putin to take on the presidency, this problem could be addressed by coming up with an attractive new candidate.

For his part, Medvedev naturally echoes Putin's "wait-and-see" message while always adding – pointedly, since this would be logically implied without being explicitly included in the script – that he does not rule out running for a second term. There can be no mistaking Medvedev's ambition to make the grade as a full two-term president – that is, maturing from a junior partnership with Putin as national leader to a more equal partnership.

It follows that we should look at how Putin's criteria are now playing out. First, the tandem's performance in the period of economic crisis and falling real incomes is highly rated by the public.

Net popularity ratings (those approving minus those disapproving) of Medvedev, Putin and the government, June 2008 – December 2009 (per cent)



Source: All-Russia Public Opinion Research Centre (VTsIOM).

Second, Medvedev himself has grown steadily more presidential. This will have become clear from our analysis in the Context section above of his evolving division of labour with Putin. It also emerges from what might be called the expected demeanour of any Russian leader. This includes imperious pronouncements and, above all, “rolling heads” – that is, the dismissal for negligence and incompetence of army generals, senior policemen, prosecutors and prison service chiefs (the latter taking the rap for the death in custody of the lawyer for Hermitage Capital Management, Sergey Magnitsky).

Second term for Medvedev

A common error is viewing such developments as spelling mounting tension between Putin and Medvedev and thus supporting the thesis that the tandem will crash. We believe that, on the contrary, to the extent that Medvedev grows into the job, Putin’s “Plan A” can be regarded as succeeding. And if that is the case, the whole political logic and momentum point to our conclusion of continuity. Like any bicycle which moves smoothly forward according to plan and without wobbling, this tandem will continue its natural path through to the end of a second Medvedev term in 2018.

No upsets in 2010

Along with this main forecast, our secondary conclusion is that all speculation about the tandem falling over during 2010 will prove groundless. First, the twin criteria for its smooth progression (leadership popularity and Medvedev’s performance) are being met. But what if our view proves wrong, and Putin’s political logic is after all overturned by personal ambition (such as an implacable desire on the part of Putin himself to return to the presidency as an end in itself)? While the possibility of that scenario cannot be disproved –

although it would fly in the face of Putin's entire track record – it is most certainly not on the cards in 2010.

Relating these fundamental judgments to the influence of political risk on Russian markets produces the following conclusions:

Downside risk

We believe that the Putin-Medvedev tandem presents no downside risk in 2010 and that the same will hold true in the run-up to the next elections in 2011. It follows that the appearance of any appreciable political risk discount in Russian asset price valuations would be attractive.

Upside risk

As for upside risk, the tandem's direct contribution will hinge on the success of key policies – especially, as noted above, in the financial sector. In the purely political area, which is the subject of this note, the Russian leadership's present course could provide an indirect boost to Russian assets' valuation catch-up potential. The instructive precedent here is the equity market re-rating that was triggered by 9/11 and the resulting international investor perception that Russia had been reforming impressively (a fact ignored by the market until that point) and had come to be "on our side".

Medvedev's political reform initiatives could have a similar effect in the present conjuncture. The attraction of Russia's discounted valuations will make international investors more receptive to reinforcing arguments – and one such argument will be that positive political developments in Russia hold out the prospect of the country becoming "more like us".

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