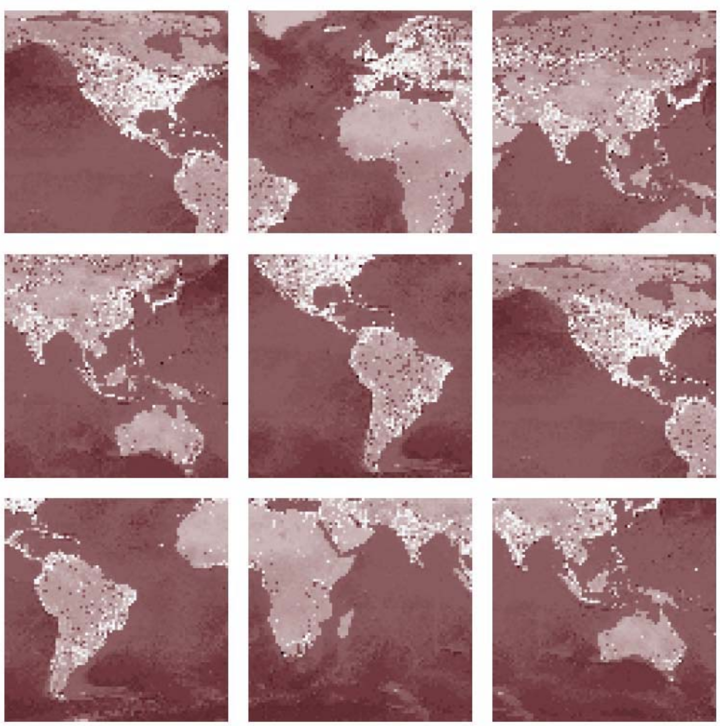
Chapter Two

Russia: A Smooth Political Transition

October 2007



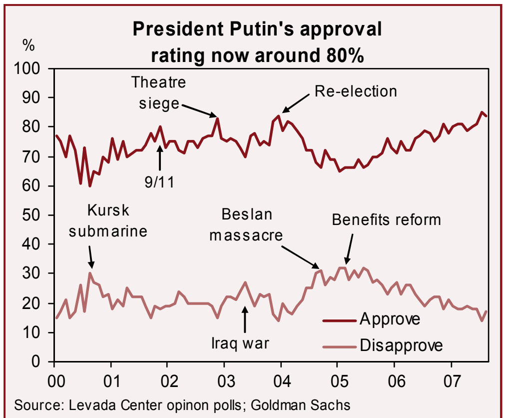
Russia: A Smooth Political Transition

On October 1, 2007, Russia's President Vladimir Putin announced that he would lead the party list of the pro-Presidential United Russia party in the upcoming parliamentary elections, and said that it was 'entirely realistic' that he could become PM after the elections. At a stroke, he has both confounded and confirmed the consensus view of how Russian politics would evolve over the coming years. On the one hand, very few observers had anticipated that Putin might move into the PM's seat after relinquishing the presidency next year (we didn't); but, on the other hand, the statement lent strong credence to the widely-held view that, regardless of where Vladimir Putin sits after the inauguration of the next President in May, he will continue to play a central role in the country's political life.

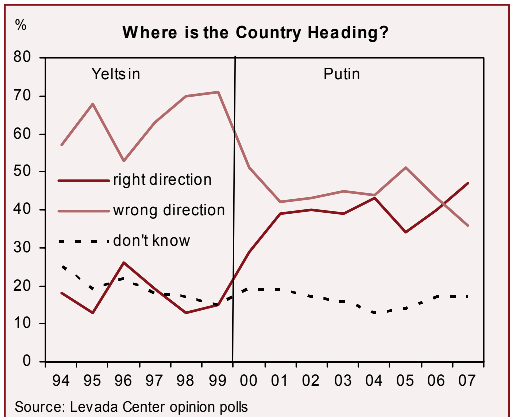
In this paper, we review the record of the Putin presidency, and argue that the Putin era is likely to continue for the foreseeable future, quite likely for another 5-10 years or more. Putin's continued presence on the political stage would all but eliminate the risk of the kind of political disorder and policy gridlock that Russia suffered in the 1990s—and that continues to hamper reforms and macroeconomic stability in neighbouring Ukraine and some other emerging market democracies.

The Putin Record

Since taking office on December 31, 1999, President Putin has presided over a remarkable resurgence in the Russian economy. After contracting 35% under President Yeltsin, Russia's GDP has grown by an average of 6.8% per year under Putin, and in 2007 economic output will be 70% larger—and household consumption 115% larger—than in 1999 in real terms. From its depressed levels after the 1998 Ruble devaluation, GDP in US Dollar terms has risen more than six-and-a-half times, while average wages have risen eightfold. Soaring oil prices have enabled the state to repair its tattered balance sheet after a decade of large budget deficits: the state has reduced its debt/GDP ratio from 150% to under 10%, and the Central Bank has accumulated \$434bn in foreign currency reserves, including the government's \$141bn oil stabilisation fund. Inflation has declined steadily from over 125% in mid-1999 to around 9%. Given this impressive economic turnaround, it may seem natural that Putin enjoys the approval of around 80% of the Russian population as he approaches the end of his second four-year term.



Source: Levada Center opinon polls; Goldman Sachs



Source: Levada Center opinion polls

Surprisingly, however, a majority of Russians do not believe Putin has been particularly successful in improving living standards: a full 54% of survey respondents say that he has been either entirely or somewhat unsuccessful in dealing with economic growth and raising living standards (64% answered the same way in a 2006 survey). This may be because the economic expansion of the last eight years has only restored Russia to its 1990 level of real GDP: for the average Russian, this decade's growth has been a recovery from the painful recession of the 1990s rather than any kind of economic miracle. When asked why people generally trust Putin, less than a third of Russians answer that it is because they believe he is successfully solving the country's problems; 30% say it is because they hope he will solve the country's problems in the future; and 35% indicate that it is because they cannot see anyone else to rely on. So, while Putin's approval rating is enviable by the standards of most political leaders around the world, and far higher than any other Russian politician's, it is to a significant degree due to the absence of any realistic alternative.

Decentralisation under Yeltsin

The lack of any perceived alternative is in large part the result of a re-centralisation of power over the course of the last eight years, reversing the chaotic decentralisation that had occurred during the turbulent 1990s. During his rule, President Yeltsin variously shared and fought over power with a number of other state and non-state actors, including his opponents in the federal legislation; directly-elected regional governors; a new oligarchy that controlled large parts of the bureaucracy, courts and legislature through corruption; managers of state-owned firms who turned them into personal fiefdoms; and media chiefs who at times used the threat of negative coverage to put pressure on or even extort money from the state.

By 1999, with the state bankrupt and the ailing President's approval rating in single digits, the Kremlin was directly controlled by a small group of business oligarchs. It was they who identified Vladimir Putin, at the time the obscure head of the Federal Security Service, as someone who would be electorally viable but who would not seek to reverse the privatisation process of the 1990s. Putin appealed to the patriotic electorate but also had an understanding of the workings of the market economy. In Russian terms, the oligarchs saw Putin as a *preemnik* (a successor) who would ensure *preemstvennost'* (continuity) rather than a reversal of Yeltsin's unpopular and incomplete market reforms.

Re-centralisation under Putin

After taking power in 2000 with a strong popular mandate, President Putin proved far less pliant than the oligarchs may have expected. He immediately began to reverse the political pluralism that had frustrated many of his predecessor's efforts at reform and had contributed to the breakdown of central state authority. His supporters forged a majority in the previously fractious Duma, and he has taken steps to eliminate independent deputies and small parties from the legislature. In effect, the Duma has been transformed over time from a staunch opponent of market reforms into a body that approves all of the President's initiatives with minimal debate.

Putin also eroded the power of regional governors, ultimately reducing them to the status of Presidential appointees. Finally, he reasserted government control over state-owned companies, either replacing the management with close allies or appointing senior administration officials to their boards.

A new relationship between the state and big business

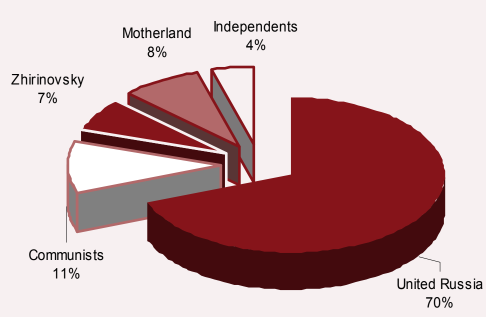
The most delicate challenge was to renegotiate the state's relationship with the business oligarchs who, by the end of the Yeltsin years, had captured much of the bureaucracy and legal system at all levels, and who had been instrumental in bringing Putin to power. The 1990s privatisation process was, and remains, extremely unpopular: to this day, nearly 40% of respondents in opinion polls say that the state should take back everything that it privatised during those years, and a further 30%-40% believe that property should be returned to the state in cases where the privatisation was proven to have been carried out in violation of the law (though the law itself was highly ambiguous throughout the period). But Putin made clear early on that he did not intend to embark on a large-scale re-nationalisation campaign, since to do so would cause economic chaos, trigger another round of bloody struggles for property at the grassroots level and (this last concern went unstated) potentially cause the oligarchs to unify against Putin.

Instead, Putin proposed a straightforward, if extra-legal, political bargain to the leading oligarchs: that they could keep the property they amassed during the 1990s if they stopped attempting to influence politics. At the same time, Kremlin allies took control of two oligarch-controlled television channels. Despite their somewhat diminished political status, the leading business groups were major beneficiaries of the Putin reforms and of the return of macroeconomic stability.

The bargain held until 2003, when Mikhail Khodorkovsky, the principal owner of YUKOS, then the country's largest oil company, launched what was widely understood to be a challenge to Putin's authority. The Kremlin squelched this independence, sending a strong signal to other business groups that have since gone to great lengths to demonstrate their loyalty. The YUKOS case proved a turning point in the Putin administration's political strategy. He appears to have drawn several conclusions from the YUKOS case:

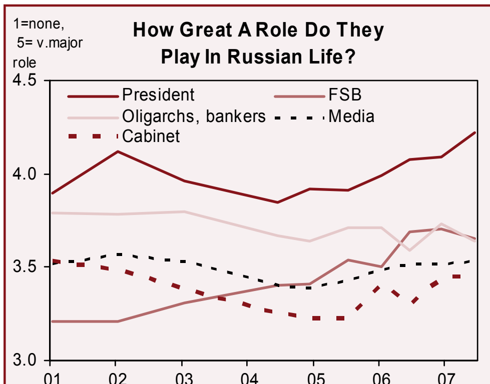
- First, that private, and especially foreign, ownership of the oil industry posed a potential threat to the nation's strategic interests, as well as to his regime's survival. The Kremlin responded by expanding the role of state companies in the sector through asset acquisitions and by deeming large new oil fields strategic and therefore ineligible for sale to foreigners.

Party Breakdown of Duma, 2003-2007



Source: Russian State Duma

How Great A Role Do They Play In Russian Life?



Source: Levada Center

- Second, Putin appears to have concluded that he could not rely on the liberal officials he inherited from the Yeltsin era for any but the most narrowly technocratic of government portfolios. Instead, he has increasingly drawn his appointees from a cadre of current and former operatives of the security services, who broadly share a common outlook that Russia is surrounded by foreign enemies and that civil liberties are a source of national vulnerability.

- Finally, Khodorkovsky's relationship with US policymakers appears to have fuelled suspicions that the US and other foreign governments were seeking to subvert or even overthrow the Putin regime, reducing Russia to the status of a compliant oil supplier. The 2004 'Orange Revolution' in Ukraine intensified these fears. The response was a crackdown on NGOs, a further tightening of control over the media, and, particularly in the wake of the Iraq war, the adoption of a more hostile and assertive international stance.

A consequence of the elimination of alternative sources of power, the increase in state control over the media, the reining in of the oligarchs, the more hostile international stance and the promotion of securities services personnel has been to empty the political landscape of any credible challenges to President Putin. As a side-effect, it has also prevented the emergence of any strong figures in the President's own camp who could credibly step into his shoes after he leaves the presidency.

The Search for a Successor: 'Operation *Preemnik*'

Under the 1993 Russian constitution, a President is allowed to serve no more than two consecutive terms in office. As the end of Putin's second term has approached, political commentators have sought to answer three related questions:

- Will Putin step down from the presidency at all?

- If he does step down, whom will he support to succeed him as President? There is little doubt that Putin's preferred successor will win next March's Presidential elections.

- What role will Putin himself play in the political system after stepping down? This was the topic of much speculation initially, but now appears to have been resolved.

In late 2005, Putin promoted two of his closest associates, Dmitry Medvedev and Sergei Ivanov, to be deputy PMs. The move was widely seen as an effort to position them to cultivate the public profile they would need to run for President. Each of the two men appeared to embody one side of the Putin agenda: Medvedev, a cautious lawyer who had worked with Putin in St Petersburg, is close to the liberal wing of Putin's team, and advocates economic openness and good relations with the west; by contrast, Ivanov, former defence minister and a colleague of Putin's from the foreign intelligence service, is best known for his hawkish foreign policy rhetoric. Medvedev was initially given greater prominence in the official media.

What Would be Best for Russia in 2008?

%	2005	2006	2007
Putin stays on as president	44	51	49
Putin proposes close ally as successor	12	10	12
Putin leaves, does not name successor	34	29	28
Don't know	10	10	11

Source: Levada Center opinion polls

Russia's Economic Collapse and Recovery

The post-communist collapse

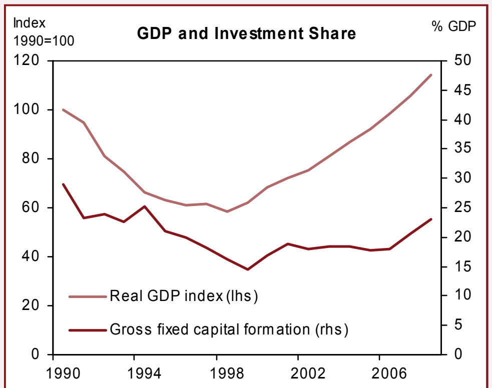
Russia suffered a deep economic depression during the 1990s. At its low in 1996-98, the economy was roughly 40% smaller in real terms than in 1990, and industrial capacity utilisation was 50% lower. After a bout of hyperinflation in the early 1990s, the authorities belatedly brought down inflation through an exchange-rate based stabilisation, leading to severe over-valuation of the currency. With oil prices low and the economy in a deep recession, the government was unable to collect taxes to cover its large expenditure commitments. The government embarked on a rapid privatisation of state-owned assets, in an at-times bloody struggle for control of the most valuable assets.

By early 1998, more than half of industrial transactions were carried out in barter, and the government and industrial companies had accumulated debts to their employees amounting to more than 10 months of wages. The government shifted from monetary financing of its deficit to issuance of short-term debt, but when the oil price fell below $10/bbl, the markets proved unwilling to finance the $1bn in weekly roll-overs. The government capitulated on August 17, 1998, defaulting on its domestic debt and allowing the Ruble to depreciate by 75%.

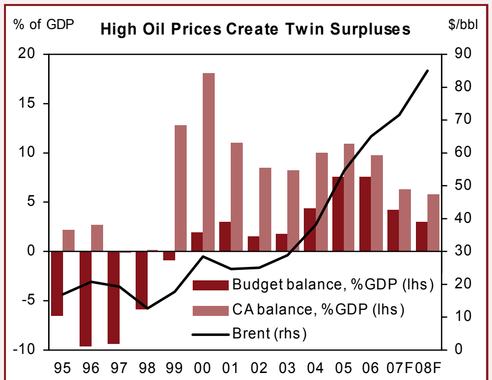
Rebound after the 1998 crisis

The country's macroeconomic indicators rebounded with surprising speed. The depreciated Ruble restored the competitiveness of many tradable sectors, while depressed imports caused the current account surplus to surge to 13% of GDP in 1999 and 18% in 2000, allowing the CBR to start accumulating reserves. Without the crowding-out effect of the government's domestic debt burden, real interest rates tumbled, domestic demand began to recover, and companies were able pay in cash. As oil prices rose, oil production, which had halved in the 1990s, began to recover, yielding tax revenues that enabled the government to pay its bills on time. Property rights remained uncertain and many structural impediments to growth remained in place, but the easing of monetary conditions sent GDP growth into double digits.

Putin took over this strong tail-wind of recovery and introduced structural reforms to address many of the economic rigidities left over from Soviet days. Between 2000 and 2003, the Duma adopted a new tax code; a modern labour code; a land code that legalised the purchase and sale of both urban and agricultural land; and a reduction of red tape and harassing inspections of small businesses. The government also launched an electricity sector restructuring, which is now nearing completion, and less successful pension and judicial reforms. The last major reform,



Source: Rosstat, GS forecast



Sources: CBR; Ministry of Finance; Haver; GS forecasts

Russia's Economic Collapse and Recovery *(continued)*

launched in 2004, was the replacement of in-kind benefits with cash payments.

External surpluses past their peak

The ongoing increases in oil prices have caused the current account and fiscal surpluses to expand. The current account surplus averaged over 10% of GDP between 2004 and 2006, while the budget surplus was 7.5% of GDP in 2005 and 2006. As oil price growth has slowed, rapidly rising imports and government spending have begun to catch up. Even using the Goldman Sachs Commodities team's bullish forecasts of oil price reaching $90/bbl by 2009, we expect the current account to fall to 6% of GDP this year, and possibly to go into balance by 2010-11, while we expect the budget surplus to fall to 4% of GDP in 2007 and to be essentially in balance by 2010. In 2007, for the first time in more than five years, Russia had a positive gross external financing requirement, meaning that its current account was not large enough to cover its maturing external debt; the GEFR is likely to rise over time as Russian companies integrate into international capital markets.

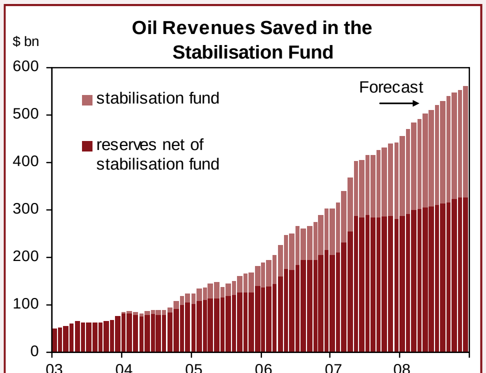
The government has saved much of its fiscal windfall in an oil stabilisation fund that receives most of the tax take from oil at prices above $27/bbl, a policy that has bolstered the state's credit-worthiness and partly insulated the economy from high oil prices. The fund currently amounts to $141bn, even after the government used $45bn from the fund to pre-pay its external debt. In 2008 the government plans to split it into a reserve fund of 10% of GDP, to be held in liquid securities, and a National Welfare Fund, which will initially be used to finance domestic investment but in future might evolve into a sovereign wealth fund that invests in foreign assets. The shift of the government's external balance sheet from net debtor to net creditor has 'crowded in' external borrowing by Russian companies and banks, which over the last two years have increased their external debt from $128bn to $343bn.

State refocuses on infrastructure

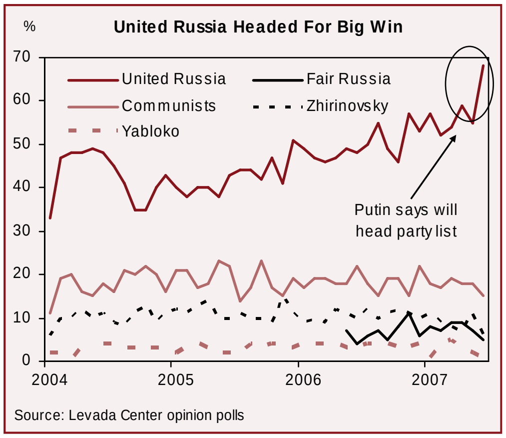
Growth over the last eight years has been 'investment-free', with fixed capital expenditures a mere 18% of GDP. While this is much better than in the 1990s, it is far below the investment rates of other fast-growing emerging markets. This has been possible thanks to the country's extensive Soviet-era infrastructure and underutilised capacity. As a result, labour productivity has grown by an impressive 6.0% annually, as underemployment has disappeared. As the economy has returned to its pre-transition magnitude in real terms (according to official statistics, Russia's GDP will cross its 1990 level this year), infrastructure bottlenecks have begun to appear in areas such as power generation and roads.

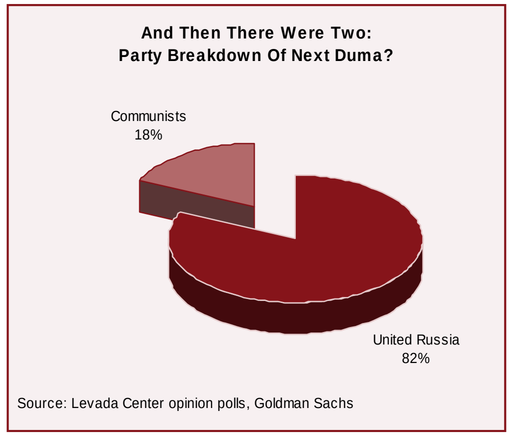
There are signs that investment has begun to accelerate over the last 12 months, with capital expenditures up over 21%yoy in 2007H1. Private investment growth may suffer a brief interruption due to the recent troubles in the local credit markets. But public investment may make up some of the shortfall: after repairing its balance sheet and accumulating a substantial 'rainy-day' fund, the government has announced ambitious plans to invest over $1trn over the next ten years in roads, rail, ports, pipelines and other infrastructure projects.

Oil Revenues Saved in the Stabilisation Fund



Sources: CBR; Ministry of Finance; GS forecasts





But as tensions between Russia and the west worsened, Ivanov has taken on additional responsibilities and pulled ahead in opinion polls.

The appointment of the little-known Viktor Zubkov as PM this September immediately thrust the former head of the government's anti-money laundering agency into the running as a third possible Presidential candidate. But we believe that it is extremely unlikely that he will be able to gain the level of public trust that it would take to establish himself as a viable candidate in the short time available. In the first polls to emerge since Zubkov's appointment as PM, a mere 4% of the population said they would vote for him, and his televised appearances in cabinet meetings have raised doubts about whether he would be ready to take on a more significant role.

Whom Putin chooses to succeed him will shed light on how strong and self-sufficient he intends the next President to be. Arguably, the most credible, confident and independent-minded of the three leading candidates would be Ivanov, who also currently has the highest popular approval rating. The least independent would presumably be the 66-year-old newcomer to high politics, PM Zubkov. Putin now appears intent on leaving the decision until the last moment, which could mean that we may not know until late December or even January.

Saying goodbye without leaving

In our view, Putin's announcement on October 1 that he may become PM—Putin described the proposal as 'entirely realistic', which we take to mean that it is highly likely—reduces the significance of his choice of successor. Before the announcement, we had expected the President to move to a bespoke position outside the constitutional framework, from which he would try to exert ongoing influence as a 'paramount leader', like Deng Xiaoping in China, or 'senior minister', like Lee Kuan Yew in Singapore. But now we believe that Putin is poised to become the next PM, the second-highest-ranking figure in the country.

But if Putin does indeed move into the role of PM after the inauguration of the new President in mid-2008, then the question is, does Putin intend to remain the de facto leader of the country, albeit from a position that is clearly subordinate to the President in Russia's constitutional hierarchy? Putin has stated that he does not intend to name a figure-head President. But it is hard to know exactly how to interpret these words. If Putin honestly intended the next President to be strong and independent, then it stands to reason that he would have identified a single candidate much earlier and given him or her the space to emerge from under the current President's shadow and establish him or herself as an independent figure in the eyes of the population. The fact that Putin has still not announced whom he plans to support as his successor, less than five months before the election date, may be partly due to indecision, as former close associates claim. But the result is that the candidate will have very little time to gain support ahead of the election. Nor will it help that Putin plans to stay very close to the centre of power, and that he has repeatedly refused to rule out the possibility that he could return to the presidency in 2012. In our view, all this evidence suggests that Putin has no intention of choosing a President who could rival him in political stature.

Whether that means that Putin intends to rule the country from another seat (for example, whether the first item on the state news channel every day will be about Putin and whether it will be Putin rather than the President who will take phone calls from the world leaders and attend the G8 meetings) is more difficult to say. Our conjecture is that Putin is likely to pay lip-service to the 'strong presidency' fiction, meaning that the next President will continue to enjoy the protocol of Head of State and will continue to represent the country at summit meetings. But we do not believe that Putin intends to allow his successor very much decision-making leeway, and we do not expect the next President to be in a position to preside over cabinet meetings or dismiss the government at the flick of a pen.

Potential Threats to the Regime

If we are right that Putin intends to hold a very highly influential role even after the upcoming elections, there is still the very important question of whether he can pull it off. Is he likely to be able to retain his authority even in a constitutionally subordinate position? We see three possible dangers:

- First, it is conceivable that policy mistakes or economic shocks could damage the popularity of the entire leadership. Traditionally in Russia, it is the PM rather than the President who has borne the brunt of popular dissatisfaction, allowing the President to dissociate himself from the worst failures.
- Second, though the next President in all likelihood will begin his or her term a far weaker figure than Putin, it is possible that over time he or she will gradually steal the limelight from Putin, or even deliberately try to undermine him.
- Finally, both Putin and the future President could face a fresh challenge from a political actor outside the current ruling group.

Risk of economic shocks or policy mistakes

The first danger is certainly plausible. The country remains somewhat sceptical of its political leaders, and blames them for its misfortunes and economic failures. Even as PM, however, we would expect Putin to try to remain above the fray of day-to-day economic policy, with deputies taking responsibility for execution and potentially taking the blame for any policy failures.

While Putin's approval rating could fall from its current high level, we see very little risk of an economic shock so large or a mistake so grave that it would threaten the longevity of the regime

Russia and the BRICs Projections

Our well-known BRICs projections imply a rosy long-term future for Russia's economy. Not only could it be the largest economy in Europe before the middle of this century but, alone among the BRICs, Russia has a real chance of catching up with living standards of the current G7, increasing its per capita GDP eleven-fold in constant Dollar terms between 2006 and 2050. We believe this is possible despite the dramatic projected population decline (from 142mn people to 109mn in 2050) and despite a steady decline in the average annual real GDP growth rate from 4.3% in 2006-2015 to 1.5% between 2045 and 2050.

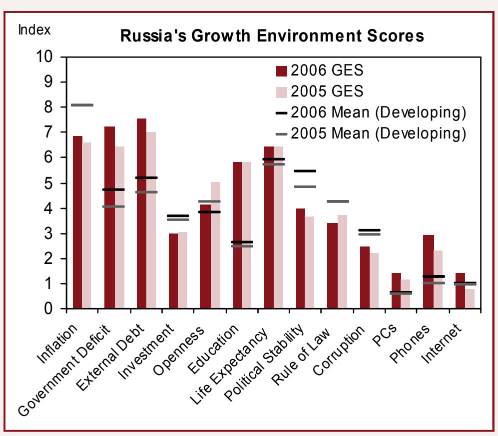
The BRICs dream is not even a 'best case' scenario—in fact, Russia's recent performance has been considerably better than projected in the original BRICs papers. But it does assume that the necessary conditions for long-run growth are in place, conditions that we have tried to capture in our Growth Environment Scores (GES). Russia scores well above the emerging market mean on education, government deficit and external debt; marginally above average on openness and life expectancy; lower but still above average on technology (phones, PCs and internet access per capita); and somewhat below average on inflation, which is now in the high single digits.

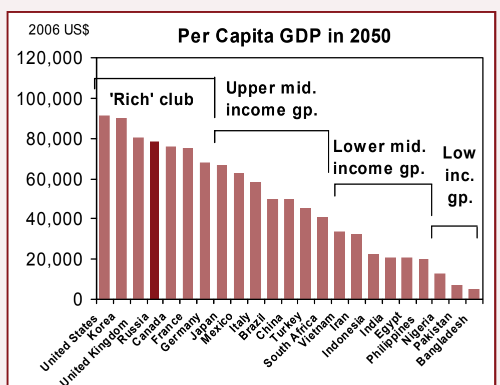
By far Russia's worst scores relative to the mean are in political and institutional variables: the rule of law, corruption and political stability. We estimate that if Russia were to move to the 'best in class' among emerging markets on its overall GES score, its growth rate would be 200bp per year higher than today. If it were to move to the 'best in class' on all the variables except for the political and institutional ones, it would gain only 136bp, forgoing 64bp per year in additional growth, an amount that over time would compound into a substantial difference.

The GES scores highlight the benefits for growth that the country is likely to enjoy thanks to the key achievements of Putin's government: restoring the country to solvency, improving macroeconomic management and imposing institutional stability after the chaotic 1990s. But they also make clear that, over the long term, Russia's highly centralised political framework is unlikely to be a recipe for the kind of sustained growth that would make the BRICs dream a reality.

% annual GDP growth	BRICs projections		Actual and GS forecasts		
	2006-2050	2006-2010	2006	2007 (F)	2008 (F)
Brazil	3.7	3.7	3.7	4.5	4.2
Russia	3.0	5.5	6.7	7.5	8.0
India	6.0	7.4	9.4	8.7	8.0
China	4.8	9.3	11.1	12.3	10.9

Fiscal Year for India.





Source: Goldman Sachs BRICs model

over the next five years. What is striking about Putin's approval rating is its sheer resilience: even at its low point in 2000, 60% of the population still said they approved of his performance. A serious shock to household incomes also looks highly unlikely. Under Putin, Russia's fiscal and monetary policies have been oriented towards creating huge financial ramparts to guard the economy—and the political regime—from external shocks. The Central Bank's $434bn in reserves could be deployed to prevent a sudden currency devaluation or to bail out failing banks, while the high tax rate on the oil sector means that the economy barely notices even large moves in the oil price, with the up-side (and potentially the down-side) largely absorbed by the government's $141bn (11% of GDP) stabilisation fund. That fund could be drawn down to maintain social spending for an extended period in the event of a downturn in commodity prices.

Over the longer term, we see a greater danger not from so much from external shocks as from evolutionary change. On the one hand, a lack of structural reform could lead to a gradual deceleration in the growth rate and a steady rise in popular dissatisfaction. On the other, higher living standards and a greater sense of economic security are likely to lead to eventual demands for greater political freedoms and pluralism, and less tolerance for the daily petty bureaucratic indignities of authoritarianism. We see neither of those processes as posing a threat to the regime in the next five years.

Risks of cohabitation

We are also not seriously concerned about the second danger, of either a significant open conflict between Putin and his successor or a Byzantine palace coup by the next President. This is true although the print media will inevitably play up any policy differences that come to the surface and there is likely to be some sniping between members of the President's and Putin's teams.

- As we have argued above, Putin is likely to choose the successor from within his inner circle, someone who owes his or her career at the top ranks to Putin and someone who will be surrounded at least at first by other Putin loyalists. Unless Putin were to start to behave extremely erratically, we see no reason why his disparate and frequently feuding allies would unite to depose him.

- Second, in our view, the entire political class will continue to recognise Putin as the ultimate authority, not least because, by signalling that he may return to the presidency in 2012, he has made clear that any effort to undermine his position would be a high-risk undertaking.

- Third, it is unrealistic to expect the next President to have anything like the political authority of Putin. It was Putin, after all, who presided over the dramatic economic recovery and political stabilisation of the last eight years—achievements that will be hard enough for the next President to sustain, let alone outdo. Putin's shoes are simply too large to fill—especially if he himself still plans to occupy them.

- Fourth, control of the television news channels would be essential in any political rivalry in high politics, and we expect Putin to ensure that his close allies continue to monitor and influence news content after the elections. Given that Kremlin control over the television channels is conducted on an informal basis, we would expect the media to take their lead from the *de facto* rather than *de jure* political hierarchy. Putin's aides already exert tight if informal control over the content of the television news.

- Finally, and most importantly, unlike all previous Russian PMs, Putin will have led the election list of the party that is very likely to hold a large majority—and quite possibly a veto-proof supermajority—in parliament. United Russia's entire political programme is based on its association with Putin. Given how hard the party has worked to associate itself with Putin personally, we believe it would be very likely to give Putin strong backing in the unlikely event that the next President were to try to curtail his powers or even remove him. We believe that a President who tries to dismiss Putin from the PM's post, though fully within his or her constitutional rights, could see the presidency's powers reduced by constitutional amendment or could even face impeachment in a matter of weeks.

Risk of political challenges from outside

The third danger (a challenge to the regime from outside) appears to be remote at this point in time. In his drive to recentralise political power, Putin has effectively emptied the political landscape of any potential rivals. The United Russia party is filled with loyal *apparatchiks*, and even Kremlin-backed political figures who have shown too much independence have been banished from the political scene. Since the destruction of YUKOS, business leaders have not opposed the Kremlin on any matter of substance, and an increasing share of the rent-generating natural resource sectors has been taken over by state-controlled companies run by allies of the President and veterans of the security services. There is a spirited liberal opposition movement, the Other Russia, but it has no access to the mainstream television channels, its demonstrations attract at most a few thousand people, and its leaders receive under 5% support in opinion polls. Only a severe external shock to the regime's stability or a split within the ruling elite would create an opening for a genuine opposition challenge—and, as we argue above, we see neither of those as at all likely in the near term.

All that said, the nature of any political system that concentrates as much power in a single individual is that it is vulnerable to an unquantifiable level of risk from entirely unexpected events—including mortality. If Putin were to leave the political scene abruptly, the security services veterans would be likely to unite around a successor to preserve their elite status. But there would be profound uncertainty in that transition.

Structural Reforms and Their Limits

Russia's strong economic performance and financial recovery over the last eight years owes a lot to rising oil prices and the extremely favourable tail-winds from high global growth. But Putin's economic policies also deserve some of the credit for proceeding with structural reforms, saving rather than spending the oil windfall, and promoting diversification of the economy through tax policy.

- Thanks to the backing of a strong legislative majority, the government was able to push through reforms early in Putin's administration that under Yeltsin had met with unyielding resistance. Since 2004, however, strong economic growth and high oil revenues have sapped some of the reform momentum of the early Putin years.

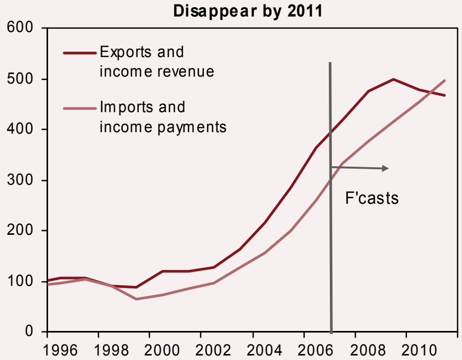
- After a decade of large budget deficits, the government has run fiscal surpluses every year since 2000, paying down external debt and more recently accumulating a $141bn oil stabilisation fund. The budget surpluses were considerably larger than planned, thanks to the unexpectedly rapid rise in oil prices, and government spending is gradually catching up with the higher revenues. But finance minister Kudrin, with the personal backing of the President, deserves credit for fighting off repeated efforts by a range of political forces to spend the surpluses. Kudrin's goals have been economic: first, to repair the country's balance sheet and enable companies to borrow, later to prevent pro-cyclical spending from driving up inflation, accelerating the real appreciation of the currency and causing the onset of 'Dutch Disease'. The minister has also been very sceptical of the Russian state's ability to spend money effectively. But Putin's support for tight fiscal policy appears to be motivated as much by politics as economics: the reduction of debt and the accumulation of fiscal reserves has reduced the country's—and by extension, his regime's—vulnerability to a possible downturn in oil prices and other potential external shocks.

- Lastly, after the tumultuous years of political upheaval, macroeconomic volatility and rapidly shifting property ownership in the 1990s, Putin's firm grip on power has given the country a degree of stability and predictability, which in turn has stimulated the beginnings of a recovery in investment. Capital investment grew by an average of +11% between 2000 and 2006, compared with -11% annually in the previous seven years. In the first eight months of 2007, it has accelerated further to around +22%yoy. This has come despite the YUKOS case and a handful of other examples of property expropriation and discriminatory tax treatment. Inward foreign direct investment has also risen, from 0.9% of GDP in 1993-1999 to 1.8% of a much larger GDP in 2000-2006.

On the other hand, the current political framework has also ruled out certain other structural reforms. The clearest example is the oil and gas sector. The state's desire to retain control over Gazprom has caused it to reject reformers' efforts to unbundle transportation from production or to liberalise independent gas producers' access to the pipeline system. This is despite inefficiencies in the current system and an imminent shortage of gas on the domestic market. Since 2004, the state has also expanded its control in the oil sector through asset purchases and renegotiation of earlier contracts (we estimate that more than 65% of the sector remains in private hands, down from 95% in 2003).

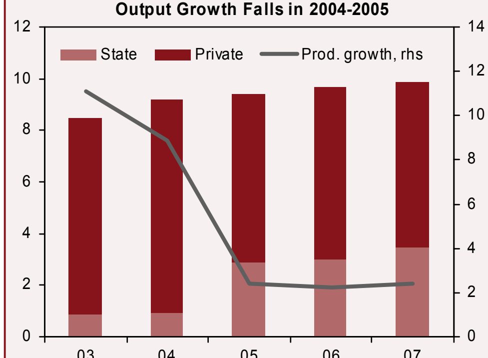
In our view, the Kremlin wants to maintain control of the oil and gas sector not because it believes that state ownership is more efficient but because it is concerned about the sector falling into the hands of its political opponents. Those hands could be domestic or foreign. Worrying that the west is seeking to subvert Russia's political stability, the Kremlin has drafted legislation restricting foreign investment in certain strategic sectors of the economy and in large natural resource deposits. Russia is far from being the only country to restrict

Current Account Surplus to Disappear by 2011



Sources: CBR; GS forecasts

State Ownership Rises in Oil Industry, Oil Output Growth Falls in 2004-2005



Source: Rosstat, BP, company reports, Goldman Sachs foreign investment and insist on a high degree of state ownership in the energy sector; in fact, in recent years that has become the rule rather than the exception, particularly in emerging markets. It should also be understood that the bulk of Russia's oil is still produced by private companies, some of them with foreign participation. But the cost of mounting state involvement in the sector has been to discourage investment and to slow the growth in oil and gas sector output, and also to create distortions elsewhere in the economy.

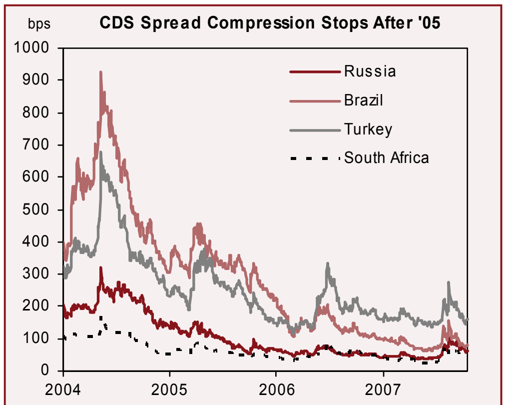
The trend towards state control has gone beyond natural resources. The Kremlin has supported the creation of state-sponsored national champions in a number of sectors, including weapons manufacturing, civil aviation and most recently ship-building. From an economic point of view, we see those moves as an example of misguided industrial policy—an effort to use the state's abundant resources to resuscitate segments of the Soviet industrial legacy that have not attracted the interest of domestic or international investors—rather than part of any grand plan to expand the state management of the economy as a whole.

Thus far, the economic costs of state intervention have been concealed by the strong recovery in the private sectors of the economy and high commodity prices, although there has already been a striking slowdown in oil production growth. Over time, however, we believe that state ownership could divert resources from productive areas of the economy to unproductive ones, as it has done in other countries in the past. The inefficiency of the non-tradables sector in turn would be likely to lead to overvaluation of the real exchange rate and a decline in economic competitiveness of the economy as a whole. We believe that if state ownership continues to grow and curbs on foreign investment remain in place, Russia will have considerably more trouble achieving the long-term possibilities outlined in our BRICs projections. The good news is that we would expect the political elite eventually to respond to declining growth rates by reversing course and returning assets to private hands.

State still not accountable to the judiciary

Putin's focus on maintaining political control has also hindered progress on judicial reform and the establishment of secure property rights, which will be essential if Russia is to raise its still low level of investment. Rather than committing itself to the protection of property rights, since the YUKOS case, the state has opted to keep the oligarchs in a state of perpetual insecurity about their assets, in an apparent bid to discourage a repetition of Khodorkovsky's political adventure. It would be wrong to exaggerate the scale of this problem: it primarily concerns the owners of a handful of the very largest privatised companies. For the most part foreign investors have escaped unscathed. But more broadly, while the Putin government has arguably made some progress in curbing private racketeering and compelling the private sector to comply with the country's tax laws and other regulations, it has resisted efforts to make the state itself accountable to the judiciary or to weaken avenues of political pressure on judges. Put another way, a consequence of the government's reliance on law-enforcement and the bureaucracy to defeat its political opponents is that it has not focused on rooting out corruption in its own ranks.

Political Stability Is Good for Asset Prices



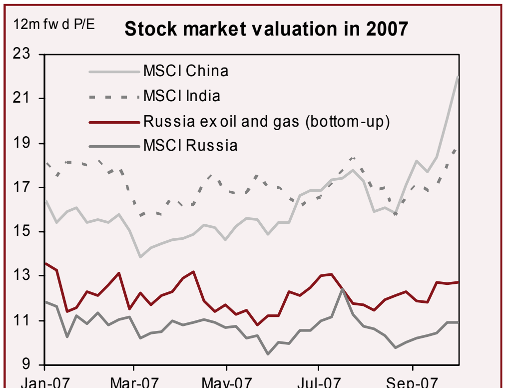
Source: GS

After several years of strong outperformance, Russia's asset prices have disappointed in 2007. Equity prices have lagged far behind the other BRICs and many developed markets, even as the oil price has set repeated all-time highs. Russia's equity valuations are now considerably lower than either China's or India's, even omitting the oil and gas sector, which typically trades at lower multiples. Credit default swap spreads on Russian sovereign debt reached a historical low 37bp in June of this year, but widened by as much as 70bp during the credit turmoil over the summer and are still more than 20bp wider than they had been. Russian credit names have been even worse hit and have yet to recover from the global credit sell-off; some leading consumer banks are now 350bp wider against the Russian sovereign benchmark than they were in early July.

In our view, asset prices this year have been hurt unduly by political uncertainty and the perception that the upcoming elections hold risk for investors. There are other technical explanations for the recent equity price weakness: first, the large volume of new share issuance in late 2006 and early 2007; and second, the heavy weight in the index of oil and gas companies, which tend to benefit surprisingly little from higher oil prices because of the structure of Russia's tax system. In credit space, the global shock over the summer, which coincided with a rise in Ruble volatility, revealed a profound lack of trust among Russia's numerous commercial banks as well as their lack of faith in the credibility of the CBR's commitments to support the system. But beyond those technical factors, we perceive a widespread sense of unease among investors about the still-unresolved Presidential succession and the belligerent foreign policy rhetoric emanating from the Kremlin in the past few months.

As we have argued above, we believe these risks are overstated. We now think that the upcoming elections will hold few surprises. The market may well react to the naming of the

Source: Datastream, GS



Source: Datastream, GS

Kremlin's Presidential candidate over the next three months: in our view, the reaction to Zubkov would be marginally negative; to Medvedev, marginally positive; and to Ivanov, who at this point is the consensus candidate, the reaction would most probably be fairly neutral. But as we have contended, ultimately the name of the successor is of secondary importance: the most likely scenario is that Putin himself will remain the country's key decision-maker, ensuring that two important contributors to the current economic resurgence—sound macroeconomic management and political stability—will remain in place.

Russia under Putin's leadership is likely to continue to pursue a more assertive and independent stance on foreign policy, since that appeals to a broad consensus among Russia's foreign policy establishment and in the population at large. This means that on issues such as US anti-missile batteries in central Europe, energy supply routes, Iran's nuclear programme and the status of Kosovo, Russia is unlikely to sacrifice what it perceives to be its national interests and historic alliances. Parts of the political elite have come to believe that the country's leverage as an energy exporter, its current account surplus and its stabilisation fund mean that it can thrive without foreign capital. But President Putin himself has stressed, even at the low points in Russia's relations with the US and EU, that he still wants the country to be open to foreign investment, even if certain sectors are partially off-limits. We do not believe that foreign policy rhetoric should have any serious impact on the fundamental quality of Russian assets, though negative headlines do appear to affect western investor sentiment. Over time, as Russia's current account surplus dwindles and the country needs to attract increasing amounts of foreign capital to finance its infrastructure expansion, we expect a greater recognition of global interdependence and a somewhat less confrontational foreign policy stance.

We remain positive on the outlook for Russian asset prices for the next year. Though investment and consumption may suffer a brief slowdown related to the recent liquidity problems in its banking sector, the economy has a lot of momentum as it completes its recovery from the 1990s recession and embarks on a capital-intensive upgrade of its infrastructure. We expect the best near-term performance in credit, where bond prices are still artificially depressed after the summer sell-off, and we see especially strong performance in Ruble-denominated assets, since the recent upturn in inflation is likely to compel the CBR to allow stronger currency appreciation next year.

Our equity strategists' favourite themes are the consumer, telecoms and retail sectors, as well as steel and pipe companies, and other names poised to benefit from the state's infrastructure spending. They also see opportunities in domestic restructuring stories, such as power generation and gas. With significant segments of the economy still private, we see considerable opportunities in direct investment.

Rory MacFarquhar
October 22, 2007