

Special Study:

RUSSIAN FEDERATION

Fight for power on
the eve of presidential
elections in 2008

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ABSTRACT

Political situation in the Russian Federation remains under the influence of preparations for parliamentary and presidential elections in 2007-2008. Fight for political influence and control over the economy has intensified between various political-nomenclatura groups trying to protect their interests in the face of upcoming reshuffling on the political scene. The most important will be the results of presidential elections, which for the most part depend on the appointment by the president of his successor. The existing system, stemming from authoritarian tradition, of interrelations and intermingled politics and business, has caused that Russia has been strengthening a presidential-oligarchic system, which is different in view of many aspects from examples followed by European countries. The mid-term stability of the political system in Russia depends mainly on the continuance of positive situation in the markets of fuels and raw materials, but in further perspective the development of Russia will be determined mainly by the ability of Russian elites to carry out necessary reforms of the state and economy.

6.1. POLITICAL SITUATION ON THE EVE OF THE 2007-2008 ELECTIONS AND PROBLEMS OF RUSSIAN DEMOCRACY

6.1.1 Balance of Forces inside the Elite Community

A break-up in the Russian political elite led to the formation of alternative ways of the country's development, to the emergence of entirely different pictures of the country's future. The existence of competing nomenclature and political groups in Putin's entourage, on the one hand, enables President Putin to stay in control without allowing a destabilization of the situation. On the other hand, it increases the risks of the system. Everything suggests that even when Putin retires from his office in 2008, he will remain the most influential person in Russia. The topic most heatedly discussed by the Russian elites is the way he protects against the risk of his successor slipping out of his control. And how he can satisfy the political ambitions of the two major nomenclature and political groups in his entourage, it is „siloviks” and „liberals”¹? The duality of the political Russian system remains in place, the country increasingly resembles its national coat of arms, depicting a double-headed eagle that looks in different directions.

By *nomenclature and political groups* (NPG) we understand alliances of groups of officials and members of the state apparatus (apparatchiks) that are not institutionalized. They act as informal alliances within which it is not vertical (i.e. relationship of subordination within a specific power institution) but horizontal

relations, based on the factor of belonging to a single team of officials who may work at different government bodies, that happen to be stronger. Among members of these NPGs there can be disputes over tactical issues, not infrequently they conflict over individual subjects, but strategically they act as a single team. They are united by a single goal – victory at the 2008 Elections.

Over the period of Putin's rule the NPGs went through several transformations, which seriously changed the configuration of the intra-elite field. Initially, in the early days of Putin's tenure, one would distinguish: the „old Moscow” group (her „pillars” being former prime minister Mikhail Kasianov and Alexander Voloshin), „Petersburg economists” (first of all, minister of finance Alexei Kudrin and minister of economy Herman Gref), and „Petersburg siloviks” (Nikolai Patrushev, Rashid Nurgaliev, Victor Ivanov). Later formed the group of „Petersburg legal experts” with Dmitry Kosak as its leader.

Further down the line the „old Moscow” group suffered considerable erosion, her component elements either losing influence (resignation of Kasianov and Voloshin, significant demotion of Anatoly Kvashnin, the former Chief of General Staff, who was appointed Presidential Plenipotentiary in the Siberian Federal District), or gradually reorienting towards other NPGs (for example, Dmitry Ustinov – towards „siloviks”). In 2006 this NPG attempted to stage a comeback by supporting Dmitry Medvedev as Successor (the leading role here was played by Roman Abramovich and Alexander Voloshin), however when in February personnel decisions of President Vladimir Putin „evened out” the successors, the feasibility of this scenario was called into doubt. It should be noted that some of this project's supporters had felt doubtful about its feasibility even earlier, one of the sings of which

¹ See: „Russia. Report on transformation”, Institute for Eastern Studies, Warsaw, 2006.

may be considered, the Governor of Chukotka's resignation request officially made public by Roman Abramovich in December 2006.

„*Petersburg economists*” gradually gave up their attempts to influence key political decisions focusing entirely on their economic functions and competition with one another (the most striking example – Kudrin – Gref). At the same time, the „*economists*” themselves (financial and administrative resource controlled by them) often times come under attack from individual members of the evolved „*siloviks*” wing (for instance, President's HR Aide Victor Ivanov can be behind the attack on the Central Bank). Their other part (represented by Head of RAO UES of Russia Anatoly Chubais) is betting on the „*Medvedev*” Project.

„*Petersburg legal experts*” as an NPG has almost lost its influence which is due to two events – appointment of Dmitry Kozak as the Presidential Plenipotentiary in the Southern Administrative District and Dmitry Medvedev tying himself with Gazprom.

The NPG, in the early 2000s called the „*security*” one, is going through the most significant transformation. At first, its leaders are changed – Sergei Ivanov, Nikolai Patrushev, Victor Ivanov take a back seat to Igor Sechin and Head of the President's Security Service Victor Zolotov. The Rosneft group set up with Sechin's participation becomes the most influential and its extended version includes: Mikhail Fradkov, Sergei Naryshkin, Boris Gryzlov, Dmitry Ustinov, Victor Ivanov, and Victor Zolotov.

Besides, two more elements have in the recent time become increasingly more obvious in the NPG's configuration: „*businessmen*” and „*loners*”.

The „*businessmen*” of the early 2000s that included „*Orthodox banker*” Sergei Pugachev and owner of Petersburg's Promstroibank Vladimir Kogan get replaced by figures associated with Rossia Bank – Gennady Timchenko, Yuri Kovalchuk, as well as Head of Russian Railways Vladimir Yakunin. Head of Rosoboronexport Sergei Chemezov may also be nominally included in the „*businessmen*” category. The clout of, and volume of assets controlled by, the second wave „*businessmen*” are by far exceed the similar „*indicators*” of their predecessors.

Another recent phenomenon – *nomenclature „loners*” who tend to gravitate towards the „*security*” wing, however this trend is selective and not fully complete. „*Londers*” would include Sergei Mironov, Head of the Federal Customs Service Andrei Belyaninov, as well as Head of the Federal Drug Control Service (FDCC) Victor Cherkesov.

In 2006 the binary division of the elite into „liberals” and „siloviks”, which was classic from 2003 (beginning of the „YUKOS case”) roughly to the first half of 2006, practically

lost its relevance. After the volume of assets controlled by the groups increased sharply and it became clear that Vladimir Putin was not running for a third term, the process of elite fragmentation began with the elite now numbering around 10 groups that should be more aptly called after the last names of their leaders. The following groups can be singled out: Kudrin, Gref, „*old Moscow*”, Sechin, Patrushev, Zolotov-Murov, „*Orthodox siloviks*” (Cherkesov, Bakunin, Timchenko), Sobyenin, Victor Ivanov. All of them are inclined to enter into situational and non-strategic alliances. Such configuration of the national elite is most likely to remain in place up to the start of the Presidential campaign (unless the President determines his successor before). Two variants are possible:

- Vladimir Putin points to his successor – elites consolidate around him, however some elite groups whose positions may weaken after his election will become latently or openly oppositionist;
- Competition between two successors is on – elite groups will have more freedom in their choice, their support will prove to be evenly distributed.

Apart from the „*classic*” elite communities controlling substantial administrative and material-financial resources, in the recent time – not without Vladimir Putin's tacit (and sometimes express) approval – groups, which hitherto had a peripheral status and were considered either as an „*appendage*” to one of the more influential „*clans*” or had a rather loose and unconsolidated structure which made it impossible to view them as full-fledged NPGs, have been gaining power. Of the „*new*” elite formations first of all should be named: „*Orthodox siloviks*” (Cherkesov, Yakunin, Timchenko), groups of the Head of the Presidential Administration Sergei Sobyenin, as well as the subgroups of President's HR Aide Victor Ivanov who has been consistently strengthening his positions from the beginning of the year. The insufficient volume of material assets under his control (Victor Ivanov is Chairman of the Board of Directors of OJSC Aeroflot, as well as Head of the Commission providing assistance to Russian expats returning from abroad) in this case is offset through administrative and human resources. Thus in early February, by resolution of the President Ivanov was appointed Head of the Inter-Agency Anti-Corruption Working Group enjoying broad powers, and from February 15 his protégé Anatoly Serdyukov – unexpectedly to most observers – took the post of the Minister of Defence.

Competition between different concepts of Russia's future is a new phenomenon. The national elite learns to think about the future and to manage it – importantly, we are talking not only their personal survival but variants of

the country's development. During 2006, all thoughts of the political and economic elites were focused in fact only on the future – everything that was happening in the country was judged against the problem of succession of power and the year 2008. In 2007 this tendency becomes even more evident. Tension in the elites is growing, there become increasingly more questions but fewer answers. At the same time, while focusing on the issue of selecting a successor and guaranteeing succession, the executive power forgets about the need to address a number of socially important tasks in the economy that increase the system's risks in the mid-term. Understandably, no one wants to start painful reforms right before the elections. Interestingly, the word „modernization” in 2006 as if disappeared from the political vocabulary. Though its delay threatens with grave negative consequences in not so distant future.

„Colour revolutions” in the post-Soviet space ran out of steam, and coming to power of counter-elite in Russia looks highly unlikely. Thus the active NPG found themselves safeguarded against a possible radical change in the elites – non-system oppositionists are still clear-cut outsiders of the political process without the slightest chance of public support or success.

However intra-elite competition is becoming increasingly tough this resulting in the fragmentation of the previously built groups and emergence of new candidates for the role of an independent centre of power (Yuri Kovalchuk, Vladimir Yakunin) who keep coming onto the scene. Such case scenario may unbalance the system. The elite fragmentation is reflected even in the public field – 2006 saw the launch of a „second power party” project – Fair Russia which became United Russia's major rival on the party field. Though perhaps in the long term, through the second power party, competition between the nomenclature groups will become more open and public, and non-public politics will be reflected in public politics.

This being the case, Putin always has an opportunity to try and reach an administrative compromise, for example, by appointing a neutral politician who has not joined any of the groups as his successor. He took this approach, for instance, when installing Mikhail Fradkov as Prime-Minister in 2004. Perhaps, it is this scenario of the future that is most likely to materialize. Then it will be necessary to maintain significant influence of current president – it is him and not his technical successor that will be the ultimate judge. In this respect, coming to power of a „successor” comparable in clout and power with the incumbent Head of State seems unlikely. Quite possibly, both V. Putin and most of the elite will prove interested in having two-round elections in 2008.

While so far the incumbent President keeps bulding an intra-elite balance with an eye to the future. By early

2007 it became conclusively clear that Vladimir Putin is not going to review the Constitution. Nevertheless, Head of the State instead of waiting for the „inertia” scenario to develop, chose to take the initiative into his own hands and personally control the „power continuity” process. At the same time, the incumbent President of the Russian Federation prefers to maintain an administrative balance and does not allow any of the competing elite groups to achieve undisputed dominance. It shows, on the one hand, in regular staff reshuffling designed to balance out the positions of the leading political and business players, and on the other, – in attempts to bring the spirit of „consensus” and „common cause” into the elite environment. Thus, for instance, in late 2006 he tried to create the appearance of an intra-elite peace by forcing the „Gazprom group” and „Rosneft group” to sign cooperation arrangements and later bringing them on board a common Russian shelf development project. And in February 2007, as a result of „Government fine-tuning”, first, the status of the main successor candidates evened out, and, second, „siloviks”, previously somewhat „lacking rights”, strengthened their positions in the executive power.

Such „orchestration” covers practically all material spheres: human resource policy, pre-start electoral process, economic policy of the state and entrepreneurial business activity, building of relations with foreign countries. So far it has been quite a success, considering the reluctance of elite groups to take risks: challenging the „general line” under today's conditions of fragmented administrative space and high level of confidence in the incumbent President of Russia is fraught with unpredictable consequences for them, which is precisely what Head of the State capitlizes on when building a strong system of „checks and balances”. In the end, as of now he has managed to ensure actual parity of the leading elite players and pave the way for implementation of the „power continuity” process.

6.1.2. Strategic Project of an Energy Superpower
Part of the policy of elite management of the future is the build-up of an energy superpower which is gradually becoming a truly national idea and the ultimate task. This idea was deliberately hyped up “towards the G8 Summit” in Saint-Petersburg which became one of the most significant events of the past year. It is both the country's and Putin's personal project who intends, on the basis of Gazprom, to build the largest and most expensive public energy corporation in the world. And, perhaps, become Chairman of its Board of Directors after 2008. On the whole we see that Putin has shifted his attention to the energy industry, including foreign political support for creating the energy super-corporation.

It is a unique project – the corporation, nominally called Gazprom+, could become the only one with excellent upstream and downstream positions. Gas reserves – essentially are Russia’s trump card in the first decades of the XXI century. Putin, too, understands it perfectly realizing that Europe’s supply diversification games are just a method of putting political pressure on the Russian Federation. In reality the possibilities of finding alternative types of fuel or alternative-to-Russia hydrocarbon suppliers are extremely scarce in mid-term perspective. And therefore Putin is offering Europe a simple deal – access to Russian production but solely in exchange for Russian concerns’ obtaining interest in sales, distribution and transportation companies. It is through this mechanism that Gazprom will be making its way into the European downstream market. And without an exchange of assets foreign corporations will not be able to operate in Russia². This simple idea is perfectly consistent with the main political concept of 2006 – the concept of sovereign democracy. It says that Russia is building a democratic society but will be doing it on its own and will suppress any forms of meddling with its domestic affairs, which could breach its security and sovereignty.

The firm reaction of Europe to gas conflicts between Russia and Ukraine in early 2006 and with Belarus late in the same year inclines V. Putin to making attempts at splitting the EU unity by making special offers to two countries – Germany and Italy. In essence, we are talking about an attempt to form a tripartite gas alliance. The Kremlin offers Germany and Italy cooperation at building the Nord Stream and Blue Stream-2 pipelines and purchase of large amounts of Russian gas Both countries would become its largest distributors in the north and south of Europe, respectively. These ideas are enthusiastically embraced by the energy business of these countries, but not their political leaders, whose stance is restrained. The position of Angela Merkel during Putin’s visit to Dresden, when she rejected the plan for laying an additional pipeline to Germany from the Shtokman Field, came as surprise for Russia, demonstrating commitment to the Common European energy policy.

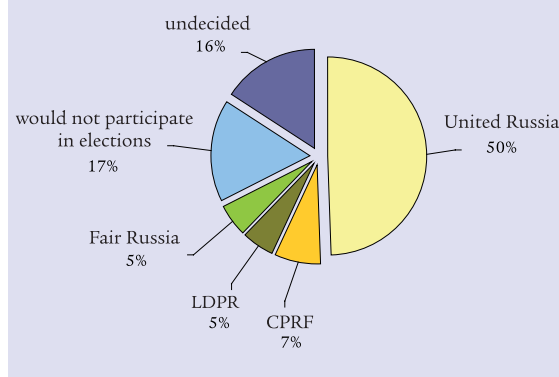
6.1.3. Balance of Forces in the Party Field

In the party and political sphere in 2006-2007 work continued to build a “transparent” party system designed to eliminate electoral risks and prevent a radicalization of the situation in the country. To a large extent it has been achieved.

² This results in a repeated consideration of the conditions for activity of the consortium dealing with the development of the field „Sachalin-2” and the position of „Gazprom” to the Shtokman deposit.

In particular, United Russia has retained its dominating position in the Russian political stage. It managed to succeed in the 2006 regional electoral campaigns and to be fairly successful in regional elections in March 2007. In parallel Fair Russia led by Speaker of the Federation Council Sergei Mironov keeps stepping up its activity, however it is not ruled out that it is meant to become rather the “left wing” of the “power party”. Youth resource has been mobilized: highly active are pro-authority movements – Nashi, Molodaya Gvardia, Rossia Molodaya, Mestnye (Ours, Young Guards, Young Russia, Locals, respectively). Their task for the future is to counter “orange” trends and “seize the street”. The “stick and carrot” policy towards opposition players (CPRF, Union of Right Forces (SPS), Yabloko) has made it possible to marginalize their individual activity. Moreover, a range of “spoilers” of traditional parties was “appointed” designed to substantially complicate their political existence (Svobodnaya Rossia – ‘Free Russia’, Grazhdanskaya Sila – ‘Civil Power’, “Patrioty Rossii – Patriots of Russia, social democrats).

Chart 6.1. Which political party would You vote for if the State Duma elections were held this Sunday? VTsIOM, June 2007



The results of elections of legislative assembly deputies in 14 regions that were held on March 11 defined the outline of the future Russian Parliament. Its change is possible but it will be technical not fundamental.

The first place with a great margin was claimed by United Russia, thus confirming its status of the dominant party. Of a total of 632 deputy seats, UR got 60.6%, Fair Russia – 13.9%, CPRF – 11.5%, LDPR – 4.9%, SPS – 1.6%, and Agrarian Party – 1.42%. In most subjects the elections were held on the basis of a mixed and not proportionate system, nevertheless the range of favourites is identified – the candidates for parliamentary seats in the 5th State Duma seats are certainly: United Russia, Fair Russia,

CPRF, and, possibly LDPR. The performance of SPS which won seats in regional parliaments can also be deemed relatively successful, which allows the “right” to count on sponsor support in the coming Duma election campaign. Such favourable results are most likely to have been achieved through a marked “leftward drift” of SPS and its use of populist rhetoric which earned it part of Yabloko’s social democratic electorate. Yabloko and Patriots of Russia proved to be clear outsiders of the election campaign.

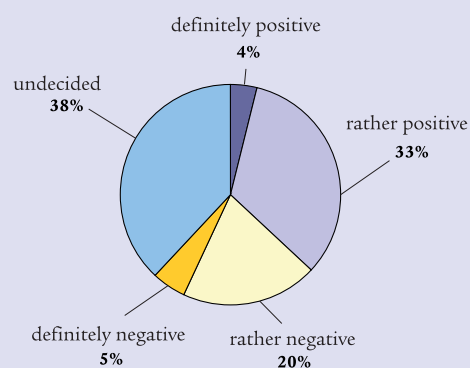
The key intrigue of the coming parliamentary campaign is the prospects of Fair Russia. Unlike UR, which has already reached its electoral “roof”, FR has demonstrated the viability of the populist strategy it selected. In many ways it happened to be possible due to increased demand for left-wing ideology in society which enabled the “social democrats”, despite the actual failure of their attempts to oust the CPRF from the electoral field, to claim acceptable results for the electoral start. It appears there are two main reasons to account for the “split” of the left electorate. First, practically in all regions both power parties focused on criticizing each other thus “forgetting” about the CPRF. This, as the decades-long history of Russian elections shows, is a “win situation” first of all for parties that do not have an administrative resource, such as the Communist Party of Gennady Zyuganov. Second, FR underachieved largely due to the conservatism of the CPRF “nucleus” electorate that could not reorient towards the newcomer over such a short period of the existence of Mironov’s party. Having said that, if FR continues its active populist policy it has a firm chance of pushing the communists aside in the left field and take a “firm” second place in the Duma Elections. However, the prerequisite to get there is the overcoming of internal dissents associated with the struggle for distribution of powers in most regional divisions of the “new left” party.

If the inertia election scenario is implemented, three parties – United Russia, Fair Russia, and CPRF are guaranteed to pass into the State Duma with UR not receiving a “control interest”. According to a “conservative estimate” LDPR which will be needed in the Parliament to block with United Russia for the purpose of forming a parliamentary majority has a fairly high chance of overcoming the seven percent barrier

Technical preparation for the 2007-2008 elections was also carried out: adjustment of the election legislation related to the cancellation of the turnout threshold and prohibition of “negative” polemics during discussions. Besides (at least at regional elections) authorities demonstrated their capabilities in terms of “forming” a comfortable electoral situation: in a number of cases lists of competitors “dangerous” for United Russia were

disqualified. Finally, election of Vladimir Churov (on March 13, 2007) who has long had personal ties with the President as Chairman of the Central Election Committee (CEC) drew the line under the debates about the role and functions of this Committee – from a body playing an intermediary role in the settlement of inter-party conflicts it turned into a “technical” structure that will implement the decisions made “above” by President of the Russian Federation himself. By this decision Vladimir Putin continued the course towards confirming his dominant position in the political system as well as took a step towards creating a post-election system of checks and balances which will restrict the freedom to maneuver for his successor and allow the incumbent President to retain the key role in resolution of domestic political issues. Election of Churov who does not belong to either “power party” and formally represents opposition (in 2003 he was elected to the State Duma for LDPR) as Head of the Central Election Committee may be also be viewed as an element of the campaign for legitimizing the results of the future parliamentary elections in the eyes of international community.

Chart 6.2. How do You rate the work of the Central Election Committee in the recent period? (VTsIOM, March 2007)

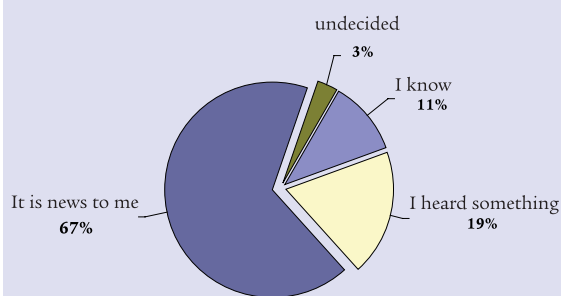


Interaction of authorities with representatives of **radical opposition** (represented by People’s Democratic Union of Mikhail Kasyanov, United Civil Front of Garry Kasparov, National Bolsheviks Party of Eduard Limonov – not registered by the Minister of Justice, Labour Russia Movement of Victor Anpilov, etc.) regardless of its ideological orientation has undergone certain changes over the last year and a half. Thus, over the past year “settlements by force” were taken to demonstrate the toughness of authorities against “anti-social manifestations”. Noteworthy in this respect are mass “preventive” detentions of opposition activists on the eve of

protest actions, initiation of legal proceedings and conduct of showcase processes (for example, “the Boris Mironov case” and “Kvachkov case”), searches in the offices of “unreliable” parties and seizure of documents.

The activity of “non-system” oppositionists peaked in the “Marches of Those Who Disagree” that took place in early March – early April 2007 in Saint-Petersburg and Moscow. The most large-scale came to be the action on March 3 in the Northern Capital which attracted particular public attention due to preparation for the elections of deputies to the municipal legislative assembly, from which was “administratively” disqualified one of the traditionally popular parties in Petersburg – Yabloko. However later interest in the “marches of those who disagree” waned among both the population and the mass media. If in the breaking of OMON (Riot Police) cordons, which came to be the “starting point”, were involved 5 to 7 thousand people, in the April actions – 2-3 thousand, the actions in June 9 and 11 gathered around 1.5 thousand together with journalists.

Chart 6.3. On April 14-15 "Marches of Those Who Disagree" – actions of the "Other Russia" Movement took place in Moscow, Petersburg and other cities? Do You know about it? (FOM, April 21-22, 2007)



The level of information resonance caused by these actions also dwindled: the key factor came to be **the new policy of authorities opted for after the loss of the information campaign around the “marches” in mid April**. Then the excessively tough reaction to the mass actions of the law enforcement agencies as well as use of force against journalists provided for a considerable number of publications sympathizing with “Other Russia” in both domestic and foreign mass media. Whereas during the preparation for the actions of “those who disagree” in May on the eve of the “Russia – EU” Summit in Samara, the law enforcement agencies focused on preventive measures (detention of organizers and activists “on the approaches”) while minimizing the use of violence during the actions themselves. It substantially diminishes the

interest of the mass media and public in such actions (in Samara, according to the most optimistic estimates, the maximum number of march participants did not exceed 300 people). To all appearances, later it was decided to give up also the preventive measures against the opposition leaders – throughout all actions in June only leader of the Red Youth Avantguard Sergei Udaltsov was detained but soon released and even managed to deliver a speech at the meeting.

The process of “virtualization” of the non-system opposition’s practical activity which started in April is still underway and further down the line may turn into a tendency. While the main direction of the oppositionists’ information activity by mid 2007 came to be the discussion about the possibility of nominating a “common” presidential candidate. As of now, at least three figures are laying claim to this role: irreconcilable critics of the current regime, pro-Western leaders of the “Other Russia” party – Garry Kasparov and Mikhail Kasyanov, as well as Chairman of the Board of Directors of NK YUKOS, Victor Geraschenko – a more complex figure who, as a first approximation, can be called a “political technocrat”. The “propagation” of successor candidates became the manifestation of a certain genre crisis currently experienced by both wings of the non-system opposition (nationalistic and democratic). In order to take part in mass politics, over the summer they have to develop both a new form and a new content of their protest activity.

6.1.4. Impact of the 2007 Elections on the Balance of Forces inside the Russian Elite on the eve of the Presidential Electoral Campaign

The cycle of elections that took part in the regions on March 11 outlined an approximate balance of forces not only for the 2007 Elections but also the party “standings” for the Presidential Elections. The preliminary results of the spring campaign allow one to speak of an increasing electoral demand for paternalistic ideology (on aggregate the CPRF and Fair Russia which actively used the populist left slogans in the last two months before the elections picked around 32% of the votes compared to 45% of United Russia), although, the position of the “right centre” represented by United Russia suffered almost no erosion. Such a “balance of forces” is quite likely to remain in place also in December 2007. Therefore it can be assumed that the key role during the presidential elections will be played by two centres of party influence – right- and left centrists (particular in the event of the CPRF blocking with Fair Russia or ousting of communists from the left “niche” by Sergei Mironov and his “team”).

We think that the balance of forces to be determined after the Duma elections will have an effect on the 2008

situation at two levels: at the level of the Presidential candidates' political platforms and also at the level of their political support.

If the leftist electoral demand is confirmed based on the year-end election results or even "expanded", the rhetoric of the presidential candidates will become more populist. Moreover, both candidates (in the event that the status of "official" successors is maintained by Dmitry Medvedev and Sergei Ivanov) will encounter certain difficulties.

Sergei Ivanov, if the current division of powers inside the Government between the first vice-premiers is maintained, will enjoy the reputation of a "non-core" official which in many ways may call into doubt the weight of his election pledges. In such situation Dmitry Medvedev will have certain advantages, however they may still be "burdened" with serious drawbacks. Medvedev's status of the person responsible for almost entire social policy in the country makes him vulnerable to criticism and automatically liable for failures of the state in this domain. In particular, deterioration of the situation in the additional medication support program, which covers around 9 mln benefit holders (if their family members are counted – around 30 mln people) may indirectly deal a serious blow to the "core" vice-premier's image, as well as provide room for manoeuvre to his rival (s).

Another potential intrigue related to the intertwining of the parliamentary and presidential elections – is the possibility of "successors" becoming members of particular parties. The final party landscape will be defined on the basis of the parliamentary election results, however already now the possible combinations may be outlined.

In the most likely case with two "official" candidates it would be logical to suggest that one of them will receive the backing of United Russia and the other – nominally speaking, of the "left forces" which may be represented either by Fair Russia whose positions have been strengthened by the parliamentary elections or the Fair Russia + CPRF alliance. In February rumour came out that both "official" candidates may become party nominated: Dmitry Medvedev – by United Russia, Sergei Ivanov – by Fair Russia. At first sight, it must be quite the opposite – Sergei Ivanov, responsible for diversification of the economy and industry development, looks more suitable under "the banner" of United Russia which at its congress in last December reiterated its status of the "party" of real deeds and made public a rather detailed program of industry development. For Fair Russia, which practically ignores the "industrial" issues but increasingly more often touches upon the socio-populist block it is more appropriate to support Dmitry Medvedev as the supervisor of national projects. However, in such case

both parties, following the candidates they support, will share the responsibility for the failures in the candidates' "core" activity which may have a negative effect on their influence on the electorate. In which case, the configuration of party support may be revised. It will be more appropriate for United Russia, positioning itself as the "lord protector" of national industry, to criticize the actions of Sergei Ivanov in this area, whereas for "socially responsible" Fair Russia – to condemn the failures in the social sphere supervised by Dmitry Medvedev.

Such configuration of candidates' party backing will add the appearance of dynamics to the election campaign which, on the one hand, will increase demand for the presence of the "ultimate judge" represented by Vladimir Putin, and on the other, – will make it possible to present to international community indications of "tough competitive struggle".

The least likely is the third variant of configuration of successors' party backing. If Vladimir Putin chooses a specific candidate, both "power parties" will have to support him (first of all, United Russia). In which case, both these structures will have to discard the legacy of the 2007 elections, radically diminish mutual criticism (if the candidate is specified after the parliamentary elections), or substantially curb its degree (if the President makes his choice during or prior to the Duma "race"), which will deal a blow to both parties' image, first of all, to Fair Russia which will have to abandon its most popular slogans and change over to a more moderate niche.

6.1.5 Problem of Continuity of Power – the Key Issue of Russian Politics

The actions of President Vladimir Putin, formalized through his statements and also by administrative and human resource decisions, are aimed at the continuity of power after the arrival of the new President. It may be viewed in a broader context – continuity of the political course, and in a narrower one – maintenance (in broad outline) of the existing intra-elite configuration.

His statements about the intention to ensure the continuity of power are mostly made during Vladimir Putin's foreign trips, or to be more precise, right before them, during a kind of President's "road show" in the foreign mass media. Claims that "the most important – is continuity of the course reflecting the interests of the majority of Russians" were primarily calculated for the audiences of the countries represented by these mass media, however the fact that these claims were "replicated" by the Russian mass media (both official and "independent") allow the assumption that they also have a domestic component aimed at maintaining the existing information background. In his speeches for "domestic" use Vladimir Putin also touched upon the issue of the

Chart 6.4. Does Russia need regular change of power through elections? (VTsIOM, June 2007)

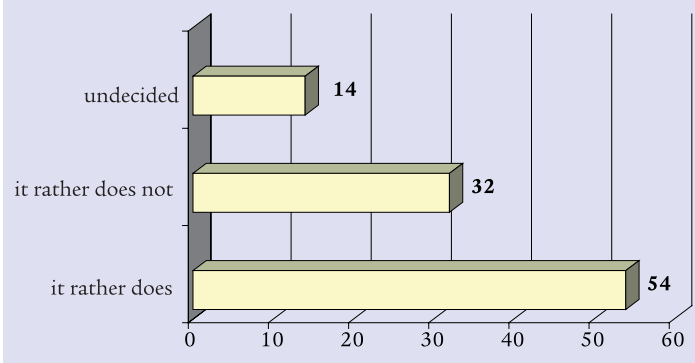
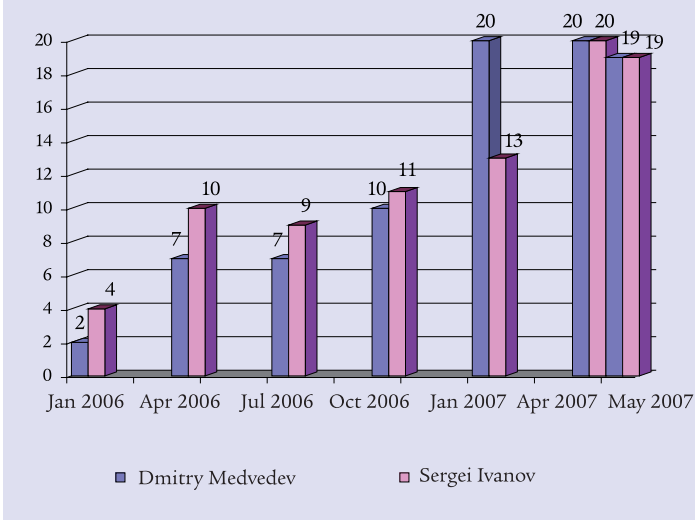


Chart 6.5. Confidence Ratings of Official Successors in 2006-2007 (VTsIOM)



continuity of power. In particular, during his annual press-conference on February 1, 2007 he said that the principal task was to maintain the high growth rate of the country. And given Vladimir Putin's impressive confidence ratings, it is the candidate for the highest official position in the country indicated by the current head of the state that will have almost 100 percent chance of success in 2008.

At this stage, the official candidates to succeed Vladimir Putin are first Vice-Premier Dmitry Medvedev ("liberal") and Vice-Premier, Minister of Defense Sergei Ivanov ("silovik"), both engaged in an unwritten competition. The basis for their "successor" status, apart from the President's support, is their employment at the highest levels of executive power with considerable scope of authority and responsibility, which is viewed as a prerequisite for "socialization" of a candidate. Prime Minister Mikhail Fradkov, holding a higher office, has the status of a "technical" premier and cannot be considered as a serious candidate.

Among the peculiarities of this "competition" two may be highlighted. First, in public both candidates emphasize that their task is to address specific business in the sectors of work assigned to them, therefore they have neither time (nor desire) for competitive struggle. Medvedev and Ivanov have said more than once they have too much work to do to engage in this kind of competition, and Medvedev even claimed in an interview to the mass media that he was upset about being looked upon as a participant of the presidential race and spoke of his friendly relations with Sergei Ivanov. This "race" stands in stark contrast to the competition of the two "power parties" – United Russia and Fair Russia, whose leaders, often on fundamental grounds, take the directly opposite stance on different issues that have public resonance. Such tactics of the two "successors" is determined by the second peculiarity of this competition – specificity of the target group their actions are meant for. This group is represented only by one man – Vladimir Putin, whose public support will largely determine the success of a candidate at the elections.

The confidence ratings (according to the results of the sociological surveys conducted by VTsIOM) of both politicians in 2006 – first half of 2007 grew rather slowly; rating fluctuations were situational, largely dependent on their (successors') representation rate in the mass media. Statistic indicators evidence that the successor competition not only does not have a leader but even a person enjoying significant confidence and authority with the public. Sociological surveys show that over 40% of the population are ready to listen to Vladimir Putin's opinion (confidence ratings of the incumbent President since early 2007, according to VTsIOM, have fluctuated within 54-56%).

The "successor" field configuration, under the President's influence, has changed at least three times. The first stage started in the autumn of 2005 after appointment of Dmitry Medvedev as first Vice-Premier who began "moderate competition" with Sergei Ivanov the latter intensifying his activity in early 2006. Then for more than half a year (June 2006 – February 2007) there was a considerable "slant" towards individual elite groups, leaning more (in actual fact or potentially) towards first Vice Premier Dmitry Medvedev to the detriment of the "team" led by Deputy Head of the

Presidential Administration Igor Sechin. “Siloviks” suffered a number of serious HR losses (departure of Vladimir Ustinov from the position of Prosecutor General, reshufflings within the Ministry of Internal Affairs, etc.), however the February “castling” in the Government broke this tendency.

By early 2007 the Medvedev-Ivanov tandem appeared to be “conserved” with the former playing the leading role and the latter – subordinate. The differences in their status (first Vice-Premier against “just” Deputy Head of the Government), level of responsibility (Medvedev – five national projects, Ivanov – Defence Ministry and security of all air flights), volume of controlled assets (Medvedev – Gazprom and funds for all national projects, Ivanov –United Aircraft Building Corporation – still under creation and, in part, defence order), and, finally, level of confidence ratings (Medvedev – 20%, Ivanov – 12% as of early February) were making the elites increasingly more convinced that Medvedev was being “promoted” by Vladimir Putin to Presidency, and Ivanov, at best, would have to settle for the position of Prime Minister. Such balance of powers, first: created a disparity in the intra-elite backing of the candidates, as well as somewhat weakened the incumbent President’s status of “ultimate judge”. Furthermore, this scheme appeared not to allow for the interests of Rosneft Group, for which neither candidacy – whether Medvedev’s nor Ivanov’s – was optimal.

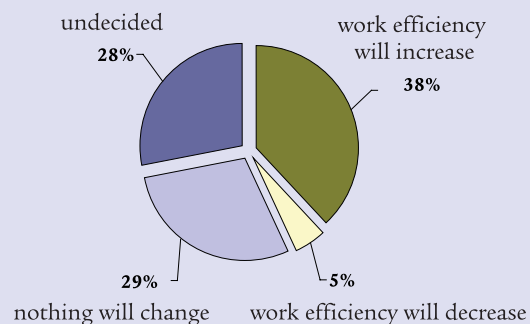
Considering these factors, it is logical that Dmitry Medvedev’s “advantage” in the successor “race” proved to be entirely situational which was clearly demonstrated by the February staff reshuffling within the Government.

During his annual press-conference on February 21 Vladimir Putin made it clear that he would not indicate his support for this or that candidate before the start of the election campaign, emphasizing that “there will be no successors but candidates for the position of President of Russia”. The “wait and see” attitude will enable the President to maintain his status of the ultimate judge as long as possible and to support the candidate that is the most popular with the electorate, since such concurrence in the opinion of the public and Head of the State will only add to his popularity. The presidential campaign may be truly competitive, where the winner will be determined as a result of tough struggle in the second round. On the one hand, such scheme will pre-empt the allegations of international community that the elections are “undemocratic”. On the other hand, the fact that there is no “absolute” winner will allow Vladimir Putin to retain the status of the most popular Russian politician even after the formal transfer of powers.

The status of the leading player in the political field was conclusively assigned to Vladimir Putin through the

February 15 personnel reshufflings within the Government and the subsequent “redistribution” of powers. Promotion of Sergei Ivanov to the rank of first Vice Premier, as well as the emergence of a new player having the Vice-Premier status – Sergei Naryshkin – finally upset the “stagnation” that had existed in the previous half a year both in the moods of the elite and in mass expectations. The broad outlines of intra-elite configurations that would define the political landscape in the Russian Federation right after the 2008 Elections (if the actual power transfer scenario is in line with “theory”) began to take shape. In our opinion, it is the elite group of “radical siloviks” that will gain most from the February “castling” and subsequent “fine-tuning” of the Government. Appointment of Sergei Naryshkin, considered close to this group, as Vice Premier while fully retaining control over the Government Office substantially adjusted the existing “imbalance of forces”. Moreover, a member of the “radical siloviks” team, Minister of Justice Vladimir Ustinov received a carte blanche to “purge” his Ministry and the subordinate structures (his predecessor Victor Chaika did not have such powers). As the first step in this direction can be viewed resignation of the head of the Federal Registration Service Sergei Movchan and appointment in his stead of a “professional prosecutor”, Sergei Vasiliev.

Chart 6.6. What will be the consequences of Government reshuffling? (VTsIOM, February 2007)



Meanwhile the competition of official successors is gaining pace and beginning with April 2007 Sergei Ivanov has been in the lead, in his statements going increasingly more often beyond his “direct” competence and sharply intensifying his activity in the media. On June 1 at the press-conference with the participation of Russian and international journalists he brought up the subject of accusations against Russia of “energy imperialism” on the part of our foreign partners, although until recently

international relations remained the exclusive prerogative of President Vladimir Putin. Generally during the conference Ivanov preferred to speak on behalf of the state as a whole and not the Government he represented. Contributing to the first Vice Premier's reputation as "successor #1" is also the rumour floating in the Moscow elite circles throughout the entire second half of May that Sergei Ivanov on these days will be appointed Prime Minister. And during his trip around the country, Vice Premier readily commented for the mass media on a broad range of issues and also afforded to "enter his competitor's territory" by voicing his opinion of the need to support the learning of Russian (this subject is supervised by Dmitry Medvedev who is the Chairman of the Year of the Russian Language Organizational Committee). Finally, the successful tests of multiple warhead intercontinental ballistic missile RS-24 as well as new cruise missiles R-500 for short-range ballistic missile complex (SRBM) 'Iskander' in the past week served as additional information causes for Ivanov's ringing statements about the defence capabilities of the country somewhat eased the negative impression after the previous failed launches of the Bulava missile.

In prospect the situation with "official" successors may develop according to two scenarios. According to the first, the intrigue will develop around the Ivanov-Medvedev tandem, while the changes to be made by Vladimir Putin might result in the "frontrunner" and "outsider" swapping places more than once. According to the second, which looks to have more rationale, the candidacy of the "real" successor will be presented after the Duma Elections when the balance of forces in the Parliament, electoral atmosphere in the society and the elite become ultimately and unequivocally clear.

While at this stage ***the incumbent President is seeking to maintain all major elite groups also after departure from his presidential post.*** First of all it applies to the "Sechin group" that will lose whichever "official" successor – Medvedev or Ivanov – is elected and will be pushed to the periphery of "big" politics and, hence, "big" business. As elements of such "advance" to Igor Sechin and his NPG may be viewed: marked strengthening of Sergei Naryshkin's administrative positions (apart from the position of Head of the Government Office he will supervise foreign trade) as well as the floating rumour that the "fine-tuning" policy may be continued by the government according to the scenario which is very similar to the proposals of Prime-Minister Mikhail Fradkov, who is by and large loyal to the "Sechin group". The emergence of rumours about the potential role of Sergei Naryshkin as the "real" successor may also be considered as a kind of "courtesy" to the "siloviks" Deputy Head of the Presidential Administration.

On the one hand, Sergei Naryshkin is distinctively different from the "favourites" of the "successors' race". First, he is a much stronger administrative player than the two first Vice-Premiers which enabled him to have a final say in the development of all significant decisions in the Government Office, while as at the time of his coming into the executive power most of this activity was concentrated in the Ministries' Offices. Second, by holding the public post of Vice Premier in parallel to the "behind the scene" position of Head of the Government Office significantly boosts his administrative "weight".

However, there are a number of circumstances that call into question the feasibility of the "Naryshkin – successor" project. By the new appointments President added dynamics to the intra-elite processes which is first and foremost in the interest of Vladimir Putin himself, for the uncertainty with the "successor's" candidacy will allow him as long as possible to lead in the political field and maintain the role of the "ultimate judge". The situation when the backing of elites will focus on the figure of Sergei Naryshkin restores the configuration of forces as at the end of last – beginning of this year, when Dmitry Medvedev came to have a confident lead in the "successors' " race. Then the elites started reorienting towards him, which created a threat to the incumbent President's retaining his influence. Moreover, Naryshkin impressive administrative skills may happen to work against him, since Vladimir Putin, to all appearances, intends to maintain his status of the "ultimate judge" also after leaving his current office. Accordingly, it would better suit his interests to have a less administratively experienced politician as a head of the state, such as Sergei Ivanov or Dmitry Medvedev (or another, administratively weak, candidate).

The new "round" of discussion of the candidates from the "unofficial" part of the potential "successor" list was prompted by the words of President's Aide Igor Shuvalov that towards the end of the year there may appear a third presidential candidate. Even though later the official delivered a statement that the mass media had corrupted the meaning of his words said at the US Center for Strategic and International Studies, it did little to alleviate the intensity of discussion about the "third force".

Different experts named up to 15 candidates among "unofficial" successors. It would be equally likely to assume that the President, preferring "unconventional" personnel decisions, will opt for one of them. Conversely though, it would be as equally likely to assume that the successor will be selected from a different list.

During 2006 many named Vladimir Yakunin – head of one of the most powerful monopolies in the country – JSC Russian Railways, who in the middle of last year was

tipped by the mass media as a likely Vice-Premier of the Government. The strengthening of Yakunin's positions is evidenced by a number of events of early 2007. In particular, it came out that structures close to Russian Railways may purchase the Komsomolskaya Pravda Publishing House which assigned close-to-it ESN Group – the formal buyer of the Publishing House – to manage its media assets in order to position these publications as independent from the monopoly.³

The emergence of this alliance and its consolidation is most likely to have received the backing of Vladimir Putin. The two main elite groups (“siloviks” and “liberals”) over the past year got significantly fragmented with the newly formed subgroups entering into fray with one another. It made them less manageable by the President and determined the need for appearance of a new “neutral” elite group. One of the prerequisites for its existence, apart from orientation directly to the President, is close intertwining of its leaders' interests which markedly reduces the likelihood of intra-group conflicts. At the same time Vladimir Yakunin is relatively well-known and not responsible for such socially troubled segments of governance as medicine, housing, agriculture (Dmitry Medvedev) or army (Sergei Ivanov). In mid May he attempted a number of image-building actions: several articles appeared in the mass media, almost identical in terms of the key topics and content, supporting the notion that Head of Russian Railways – is the most promising candidate for presidency. And at the end of May he gave a press-conference, which was formally concerned only with railway transport, but at the same time touched upon “mass” subjects directly relating to a considerable part of people, for instance, changes in the methods of fare payment on electric trains (suburban).

Among other successors are named two regional leaders – Governor of Saint Petersburg Valentina Matvienko and Head of the Presidential Administration Sergei Sobyenin. Matvienko confidently runs Saint Petersburg and on the whole enjoys the President's

³ It is possible that apart from the assets controlled by Russian Railways Vladimir Yakunin will be able to use as resources the assets of a new influential grouping, conventionally called “Russians”. This group includes Rossia Bank, Surgutneftegaz, Severstal, oil trader Gunvor exporting at least one fourth of Russian oil. The group also controls REN-TV and TRK Peterburg. Its leaders are thought to be the owner of Gunvor and one of Rossia's shareholders, Gennady Timchenko (former colleague of Vladimir Putin), and Rossia's shareholder Yuri Kovalchuk.

Russian Railways and “Russians” (first of all Timchenko) are linked by common interests. First of all, both Gunvor and Russian Railways have close partner relations with Severstaltrans – one of the major commercial carriers. Previously Vladimir Yakunin was a member of Rossia's Board of Directors. Lasting ties between him and Timchenko are evidenced by appointment in July 2006 of Igor Romashov, formerly Director General of Transoil and Link Oil SPb, associated with Timchenko, as Head of the Federal Railway Transport Agency.

confidence, which was once again confirmed when on December 6, 2006 she put the question of confidence to head of the state seeking extension of her governor's term. She explained such decision by saying that the coming year will be difficult, elections for the Saint Petersburg legislative assembly and parliamentary elections will be held, and it was necessary to maintain stable power in the city. The President did not deny her his confidence. However, later her administrative positions were undermined by the success of the “March of Those Who Disagree” in Saint-Petersburg which was accompanied by rather clumsy counter measures on the part of the local authorities.

In 2006, the Head of the Accounts Chamber Sergei Stepashin noticeably intensified his activity focusing efforts on the relevant fighting against corruption: the results of special operations carried out jointly with FSB received broad media coverage, several assistant auditors were dismissed, auditor Vladimir Panskov tendered his resignation. Stepashin also strengthened the positions of his own agency by having the Government to issue a Resolution making it binding on all state-funded structures, first of all, the largest budget spenders – Federal Ministries and Agencies – to monthly submit to the Accounts Chamber financial statements on the spending of budgetary funds according to the forms approved by the above Resolution of the Cabinet of Ministers.

The official, maintaining the image of a corruption fighter (including at his own agency), is to a large extent “equally distant” from the main elite groups and relies first of all on the resource of Vladimir Putin's confidence. For the President it is one of the most “convenient” second tier successor candidates: Stepashin has a reputation of a responsible and full of initiative executor, oriented towards the supreme authorities and incapable of playing a “big” game on his own. The new president of the Russian Federation with such psychological characteristics would quite satisfy Vladimir Putin intent on maintaining considerable influence on the ongoing processes in the country also after leaving his office.

Speaker of the Federation Council and leader of a new party – Fair Russia, **Sergei Mironov**, without doubt has presidential ambitions but he is too dependent on Vladimir Putin to reveal such intentions in any way in public. For now, he has settled for the position of the leader of a political structure seeking to become the second “power party” after United Russia, yet he is consistently running a PR-campaign to support his popularity and build the image of an active and successful politician. The key component of this process in late 2006 – first half of 2007 became the promotion of the “third

term” theme: Mironov came up with an initiative to hold a broad discussion with regional parliaments of the possibility of lifting the restrictions on the number of consecutive presidential terms for one person (currently the Constitution allows a maximum of two) and of extending the tenure of Head of the State to 5-7 years. This political step was made by Mironov to resolve his own political tasks – first of all, to increase the confidence ratings among people loyal to the current president who, as opinion polls indicate, are in the majority.

Having said that, Sergei Mironov is unlikely to count on becoming the successor to Vladimir Putin. The efforts he is making are aimed rather at promoting the main political project of Chairman of the Federation Council – Fair Russia party, set up in 2006 with the support of the Presidential Administration after the merger of the Russian Party of Life, Rodina, and Russian Party of Pensioners. The “backup power party”, whose positions on the “left” flank are not stable enough yet, in future may become an important resource: it is not ruled out that the new alliance will work for one of the potential presidential successors.

Another nominal successor candidate is the Presidential Plenipotentiary in the Southern Federal District, Dmitry Kozak. Rumours that he will be transferred to work in Moscow in the position of prosecutor general, a new deputy prime minister for regional development, head of the recently established investigative committee under the prosecutor general’s office with subsequent promotion up to the presidential office have regularly appeared in the mass media over the last year and a half but have never been confirmed. Kozak’s great plus is that he belongs to Vladimir Putin’s closest circle, minus – distance from the Federal Centre, which came as the consequence of this politician’s desire for independence and toughness. While the key factor preventing his “promotion” may turn out the role of “crisis manager” performed by Kozak in the position of the presidential plenipotentiary in the potentially “explosive” regions of Southern Caucasus. Maintenance of stability in the South of Russia on the eve of the parliamentary and presidential elections is a strategic task, and departure of Kozak, who has demonstrated his ability to prevent the escalation of conflict situations threatening to grow into a military standoff, from office of plenipotentiary may prove to be inexpedient.

One more potential nominee for the presidential post is Director General of FGUP Rosoboronexport Sergei Chemezov enjoying the resource of Vladimir Putin’s confidence and opposing Sergei Ivanov in the area of control not only over arms exports but also the defence order. Chemezov’s positions got a strong boost late last year: his organization obtained control over the exports of

Russia’s largest arms manufacturers, and at the Congress on 2 December 2006 Chemezov was elected a member of United Russia’s Supreme Council. It marked the beginning of entry into the information field of this heretofore entirely “shadow” player. In late May Sergei Chemezov – in a more “veiled” form than other members of the second part of the successor “short list” – conducted several image-building actions such as publication in the press of positively coloured materials about his activities and potential political prospects.

Finally, in the spring of 2007, Defence Minister Anatoly Serdyukov joined the list of potential candidates for the post of Russian President. In May Head of the Defence Ministry, who yet from his time at the Federal Tax Service received the reputation of an official totally closed to the mass media, all of a sudden gave an extensive interview to the *Rossiiskaya Gazeta*. The issues covered in it concerned only army problems but its greater part was dedicated to the most high profile subjects – non-statutory relations, civilian control over the military forces, etc – which considerably expanded its target audience and increased the interview’s public effect. It is possible that such claim to publicity means the start of “promotion” of the Defence Minister as a potential presidential candidate. It is also a possibility that such “move” was provoked by the rumours of the forthcoming appointment of Sergei Ivanov as prime minister, since in this case it is Serdyukov that is one of the candidates for the seat of the defence deputy prime minister.

During 2007, Vladimir Putin should be expected to make at least one landmark move in terms of the successors’ “castling” that will come in the summer or autumn – on the eve of the parliamentary elections which will enable him to maintain the initiative in the political field. Very likely are unexpected personnel decisions of the Russian President on the eve of or right after the parliamentary elections. It is safe to predict that in the near future the mass media and experts will intensify their attempts to find the “real” successor, which will lead to an increase in the number of potential candidates. President Vladimir Putin will keep making statements and promote different officials which will serve only to disorient observers and to maintain political initiative in his hands. Moreover, quite possible is an even further reduction, if not disappearance, of the gap between the “official” and “unofficial” “successor” candidates as well as the evening out of Sergei Ivanov’s and Dmitry Medvedev’s positions.

6.1.6 „Sovereign Democracy”:

Ideological Support of the Continuity of Power

The question of ideological support of the “successors” activity is extremely important at least for two reasons. First, a politician with presidential ambitions must be able

to distinctly and clearly outline his vision of Russia's future and the ways of achieving it. It is all the more important considering the insufficiently "detailed" and "compromise" ideology of the current president, whose main principles and objectives are based on specific actions rather than on program concepts. But if for Vladimir Putin such position is fairly justified, since for him it is important to maintain the intra-elite "balance", it is not for a new Presidential candidate. The latter must clearly and unambiguously define his benchmarks so as further down the line the electorate and the elite can judge what general line this "heir" candidate is pursuing. If he is too flexible, his political opponents may easily accuse him of deceit, double-dealing, unscrupulousness, and other "sins".

Second, it is necessary to link the main ideologies of successors to the ideological positions of the major parties currently acting in the Russian political field. It should also be taken into account that officially neither Dmitry Medvedev nor Sergei Ivanov is official representatives of any party, which in principle is not very important: for the Russian society of 2007 more important appear to be personal characteristics rather than affiliation with these or other structures. However as the Presidential elections draw nearer the problem of an ideological union or separation between the main candidates and parties they were nominated or supported by will become increasingly vital. Thus ideology in Russia is an embodiment of the interests of bureaucratic corporations united into informal yet quite influential groups. In this respect, it does not matter who personally will become the President of Russia in 2008. Of far greater importance is which of the nomenclature and political groups will have the upper hand in the struggle for the right to control the executive power after Vladimir Putin's departure, and which project of the country's development will be selected for implementation. In this respect both elites are appealing to the current president as the principal judge, who will have to make his choice as to the country's future.

The term "sovereign democracy" was introduced by Vladislav Surkov at the meeting with the active members of United Russia in February 2006 as the political benchmark Russia should strive for. In June, Deputy Head of the Presidential Administration called "sovereign democracy" "our Russian model of democracy" as opposed to "controlled democracy", in response to the reproaches by members of Western political circles and the mass media.

The most heated discussions of the term "sovereign democracy" began from the mid summer of 2006 and were caused, first, by statements of high ranking state

officials and, second, by the start of the process of developing its own program by United Russia, which was necessitated by the approaching 2007 elections of State Duma deputies.

In mid July, seizing the initiative from "liberals" Sergei Ivanov published an article in the *Izvestia* which can be considered his program statement. The Minister of Defence reinforced that society must rally around the "new triad" of national values. In his opinion, it is – sovereign democracy, strong economy, and military might. Developing the ideological justification for Russia's "conceptual independence" the Minister noted that Russia has for goods abandoned the "confrontational model in the 'East-West' system and its actions in the international arena have become more pragmatic. He stressed that Russia has acquired a new status of an energy superpower and at the same time has reclaimed the status of "a great powerhouse holding global responsibility for the situation on the planet and the future of human civilization".

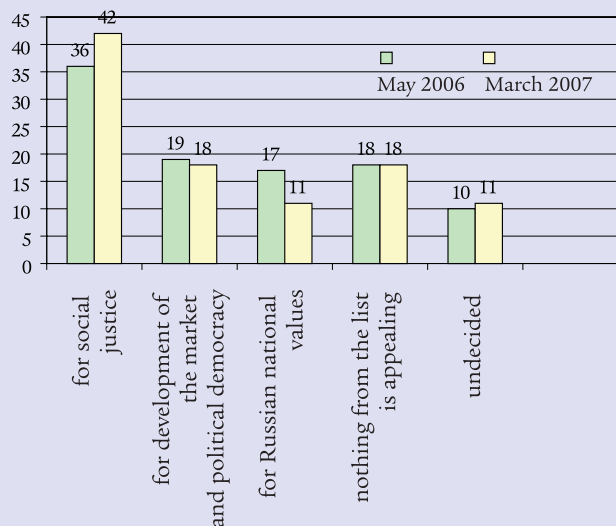
The Minister also explained the meaning of the new national values. According to Ivanov, "sovereign democracy – is the quintessence of our internal organization implying the right of citizens themselves to define the policy in their country and to protect this right against external pressure by any means necessary, including military". To this end, he believes, a strong economy is required to ensure high living standards and meet the material needs of Russians, while at the same time providing for a high level of the country's defence capabilities.

As far as the military might is concerned, "its maintenance and build-up are possible only subject to the highest level of development of state-of-the-art technologies and availability of a powerful production base". Generally, the article pays great attention to the foreign policy as well as military and strategic aspects of Russia's future, which of course is due, among other things, to the current position held by Ivanov. However, it is the "sovereign", state-oriented rhetoric that may become a distinction of the siloviks' ideology, who have to base their ideological constructions on the "sovereign democracy" concept, approved by the President.

Because Sergei Ivanov was the first of the candidates to make use of the popular term "sovereign democracy", Dmitry Medvedev was also obliged to refer to this term. It is exactly what he soon did in an interview to the *Expert Magazine*, where he attempted to cast doubt on this term calling it "unilateral and obscure".⁴

⁴ Dmitry Medvedev's statement was interpreted by observers as a token of conflict between members of the "liberal" group, even though the discussion went within the framework of the competition between the two probable candidates to succeed Vladimir Putin. By that time the concept of "sovereign democracy" was viewed already as an ideological model of the state as a whole. Even though as at that

Chart 6.7. Which ideological and political movement appeals most to You? (VTsIOM)



The discussion was joined also by the deputy head of presidential administration Vladislav Surkov published in November 2005 an article, “Nationalization of the Future”, in the Expert Magazine in which he attempted to construe the term “sovereign democracy”, differentiating between national values and national affairs. Vladislav Surkov offers as national values a triple formula of “freedom, justice, and material well-being”.

As regards the national affair, the Surkov’s ideas correspond to traditional Russian political thought (it will suffice to mention Vladimir Soloviev, Nikolai Berdyaev, or Ivan Ilyin, the latter being quite revered nowadays by almost all elite groups): emphasizing the role of the Russian nation as a political and spiritual centre of influence, etc.

6.1.7. Situation Development Scenarios for 2007-2008

It can be forecast that the next president of Russia will not hold office more than once and that he will prove a relatively a weak and “light-weight” political figure. Moreover, the successor will not be elected triumphantly, in the very first round, but, to all appearances, only in the second with a slim advantage over his rivals. It is required as a safety net for Vladimir Putin, who will continue to actually run the country even after his official resignation, against excessive ambitions of the third President of the

time the President of the country had not yet made any public comment on this issue, “sovereign democracy” was deemed to be de facto approved by him (later he remarked that he had no objections to the use of this term).

Russian Federation. By the way, it cannot be ruled out that in the course of such electoral “casting” both official candidates – Dmitry Medvedev and Sergei Ivanov – will cross swords to determine the winner in a head-to-head showdown.

The most important problem facing Vladimir Putin will be to maintain the intra-elite balance and prevent a direct clash of interests of the leading elite groups – “siloviks” and “liberals”. It will prove an uphill task, since each of them fears that in the event of Putin’s leaving office, the “status quo” will be radically upset to be followed by a repeated drastic division based on the “winner takes it all” principle.

From the point of view of the current perspective, two scenarios can be outlined: a compromise and a conflict one.

The first variant anticipates a relatively seamless exit from the process of power transfer in 2007-2008. It will happen if a “compromise” figure of Vladimir Putin’s successor is picked or the incumbent president of the Russian Federation for whatever reasons will extend his tenure. In this case, the national establishment will continue to be divided into nomenclature groups, whose status will be directly dependent on their “capitalization”, that is possession of power resources (first of all, economic and information ones). By the way, it is not ruled out that in this case, going by the principle: “if you can’t beat your enemy – embrace him”, the NPGs will enter into a kind of inter-elite “non-aggression treaty” which will be pinned up by the foreign policy challenges and interests of joint business expansion overseas.

The second scenario for the development of situation assumes confrontation between the nomenclature and political groups. It is not ruled out that in the absence of a clearly indicated successor of V. Putin, the inter-elite struggle will enter a maximally conflict-prone phase, accompanied by a sharp increase in the political activity of the opposition forces, growing instability in the country, high-profile assassinations designed to spread confusion in the national politics, play its different elements against each other, trigger a surge of violence. In which case, a significant role in the instigation of intra-elite struggle will be played by “anti-system” internal and external forces, since a disintegration of the “double line-up” team of Vladimir Putin will largely mean also a collapse of currently shaky balance.

Even if during these troubles, the current political regime manages to cling to power, it will suffer substantial image and resource damage. Moreover, in the event of a total victory of one of the NPGs over its rivals it will be followed by a severe purge of the “rival’s” representatives

holding government offices and belonging to the business community.

As for the party and political prospects, here election of the fifth State Duma of the Russian Federation will become the most important event, which in many ways (in extreme scenario in administrative terms) will turn into a competition of the two “power parties” – United Russia and Fair Russia. Yet, it cannot be ruled out that their confrontation will be largely pretended. In the end, the first place will be taken by United Russia though it will hardly have a constitutional majority at the State Duma, while the second place will be in the sights of several structures at once – Fair Russia, CPSU and LDPR. As far as the “right” forces are concerned (SPS, Yabloko), they are most likely to get the right to participate in the elections but will fail to agree on a common list and will follow separate ways. Furthermore, in their striving for a *carte blanche* to be among the winners, they will reduce the level of opposition rhetoric, but eventually they will hardly be allowed to overcome the 7% barrier.

Such a balance of power in the Lower Chamber of the Russian Parliament will make it possible to perform the succession of power relatively quietly and according to plan and later legitimize the new President through the “pro-authorities” majority of the State Duma.

Having said that, in 2007-2008 public protests will be growing. It is due to several factors. Firstly, broken out electoral struggle will itself provoke growing demands of different categories of the population who will try to capitalize on the “favourable” conditions in order to make their claims heard by the authorities. Secondly, “public politics” may intensify resulting from attempts of individual political structures to try and play the “populist card.” At last, thirdly, Russian authorities represented by the leading nomenclature groups must be prepared for the attempts by the radical opposition and certain external forces to destabilize the situation in the country, or even have a go at the “orange scenario”.

Nevertheless, the availability of significant financial resources (as a result of high energy prices) allowed the authorities to, by and large, successfully curb protest sentiments. It is true not only for such key areas as politics and economy, but also for related fields. For example, increased financing of science, education, medicine, military not only enables their development but also secures loyalty of employees involved in these industries. Moreover, individual categories of the population (doctors, teachers) may become “advocates” of the official course during the 2007-2008 elections.

At the same time it can be predicted that in the foreseeable future economic problems will become insignificant. The leadership of the country will totally give up on carrying out “unpopular” infrastructural reforms in

favour of a “socially oriented” policy. Accordingly, economic risks will grow (communications depreciation, energy supply problems, workforce shortage, etc.), whose exacerbation later may seriously compromise Vladimir Putin’s successor.

Private business is unlikely to suffer as well: most Russian “oligarchs” have already pledged allegiance to some or other influential administrative groups and “successors”, domestically there are almost no lucrative “available” economic assets left, therefore, 2007 is expected to become a period of relatively peaceful co-existence of the entrepreneurial community. This being the case, part of them will make use of the situation to consolidate its positions inside Russia, while others – on the contrary – will make attempts to export capitals abroad so as to avoid post-election risks.

It is safe to say that on the eve of the new election cycle, both the NPGs and official successors will be actively promoting the idea of creating an “energy superpower” and expansion of leading Russian companies into foreign markets. In this respect, state-owned companies Rosneft and Gazprom will prove the most active.

While the foreign policy on the eve of the commencement of the power transition process will find itself almost in the spotlight of the Russian political leadership. The point is that in any case international legitimization of the past parliamentary, and later – presidential, elections will be required. That is why it is not on Putin’s agenda to exacerbate relations with the West (above all, the US) which are currently setting the democracy criteria for this or other election campaign as well as for this or other regime on the whole. Furthermore, after leaving his office Putin plans to retain not only domestic but also foreign policy influence, therefore he will do all it takes for the results of the “Successor” operation to be recognized at the international level.

6.2. FIGHT FOR ECONOMIC INFLUENCE

6.2.1. Financial policy

The macroeconomic situation of Russia in 2006 was conditioned by the standoff of the major interest groups in the “economic block” of the Russian Government. Different approaches to state governance directly affected the annual indicators of the country’s development.

Until recently, the monetary policy of the Russian Federation consisted in reducing the pressure on strengthening of the ruble. The Central Bank of Russia (CBR) purchased liquid dollar assets and lowered the mandatory reserve requirements on a planned basis. Since March 2004, the requirements for most types of

borrowing were lowered from 10% to 3.5%. In parallel, the Ministry of Finance would “cut off” dollar surplus from oil exports transferring it to the Stabilization Fund. Yet, “black gold” prices grew by leaps and bounds and huge volumes of petrodollars still made their way into the market of the Russian Federation. In its turn, it spurred inflation which reduced both government expenditure and the investment appeal of the ruble.

However, after the failure of the inflation plans for 2005, the financial policy of the Central Bank changed. “Total” (“strict”) strengthening of the ruble became a strategic priority. It was prompted, among other things, by the spring address of the President where the slowing down of the devaluation of the national currency was declared a pivotal goal. The Central Bank all but ceased its currency interventions with respect to the dollar, which resulted in a significant strengthening of the ruble. Besides, the reserve requirements were substantially reduced.

Beginning with the meeting with Minister of Finance Alexei Kudrin on August 22, 2006 President took the course towards preventing a serious strengthening of the ruble. It was noted that the strong ruble can undermine the competitiveness of the national economy. It applies first of all to major exporters (raw material companies) whose products are denominated in the US currency. Moreover, the higher is the added value of a product, the higher are costs incurred by the manufacturer. Hence companies with the highest margin become the most vulnerable. In the national economy such are primary, secondary and tertiary processing structures big metallurgic enterprises (ferrous and non-ferrous metallurgy with high added-value): Severstal, EvrazGroup (rolled steel); Rusal, Sual (aluminium); Norilsk Nickel (nickel and copper); UGMK (zinc); VSMPO-Avisma (titan and magnesium). Their direct competitors in world markets receive significant preferences due to weak national currencies (because of exchange rate differences). Thus their production costs will be markedly reduced, whereas our national companies will be losing profit.

However, the greatest damage was done to the domestic enterprises, which loose in competition with foreign manufacturers also in the domestic market. What is more, non-residents are ousting Russian companies from the national market. Imports are on the rise: in 2003 imports were up by 25%, in 2004 – by 28%, in 2005 – by 29%, in 2006 – by 27%. It reduces also Russian budget receipts, for foreigners pay the major taxes at the place of their registration.

Trying to counteract it, Russian authorities apply three types of measures. Each of them is pursued by a specific interest group within the Russian Government.

The first – is customs regulation allowing one to keep in check dollar money supply by increasing duties. Hence,

the “washing out” of roubles from the market is reduced. This project was actively lobbied by Minister of Agriculture Alexei Gordeev speaking openly in favour of retaining quotas and restrictions on meat imports. The major drawback of customs duties is a limited area of application: protecting domestic producers, they are less efficient when it comes to exports. This mechanism is implemented by the Federal Customs Service of the Russian Federation, which is closer to the “siloviks” interest group.

The second measure – is the monetary policy of the Central Bank (primarily, currency interventions (dollar purchase) and increasing the reserve requirements). This mechanism is supervised by the Head of the Central Bank, Sergei Ignatiev. However, the position of the Bank of Russia was markedly weakened after the introduction to the State Duma of a draft law on full ruble convertibility.

The third is sterilization of the greater part of export revenues by accumulating them in the Stabilization Fund. This strategy is implemented and actively lobbied by the Ministry of Finance headed by Alexei Kudrin. According to his strategy, 80% of the ruble rate control mechanism will be at the disposal of the Minister of Finance and only 20% – of the Central Bank. To this end, it is proposed to tighten the spending of budgetary funds.

The Central Bank’s response to the Finance Minister’s proposals was increasing the reserve requirements for obligations to foreign banks, which from October 1, 2006 were raised by Ignatiev’s Agency from 2% to 3.5%.

On top of that, Head of the Ministry of Economic Development and Trade (MERT) actively stepped into the fray, promoting the idea of creating a national export support agency with the financing in the amount of 2% of budget expenditure. It is proposed to transfer the main exporter support functions to the ministry. It is planned to take away the right to grant state guarantees from the Ministry of Finance and the right to subsidize interest rates – from the Ministry of Industry and Energy.

So, the main struggle for control over the economic policy of the Russian Federation in the past year went on among four agencies: MERT, Ministry of Finance, Central Bank and Ministry of Agriculture. The standoff along the Gref-Kudrin line assumed the greatest significance. Both Ministers substantially modernized their projects which considerably furthered their implementation potential.

The Minister of Finance proposes to replace traditional budget planning by task-based budgeting (result-oriented budgeting – ROB) and complementing the budget with non-oil and gas revenues (Main assumptions were included in the document “Methodology of preparing the balance sheet of Russia’s budget based on non-oil and gas revenues”). Essentially the proposals of the Ministry of Finance boil down to using

“separate accounting for oil and gas (raw material) and non-oil and gas revenues”. Alexei Kudrin proposes to manage these revenues in a special mode: withdraw them from the economy to a separate Fund with a special expenditure administering procedure or, in extreme case, account for them separately. The objective is unchanged – creation of a “non oil and gas budget” which was proposed as an exporter support and ruble weakening measure. It is assumed that the establishment of the fund will encourage dollar sterilization, which should reduce the pressure on the ruble, while the Russian currency, cheap relative to the dollar, will ensure a significant competitive advantage to domestic exporters in foreign markets.

The Head of MERT also substantially modernized his National Export Support Agency project. It was re-worked into a comprehensive plan for industry and technology development for 2006-2007 which was introduced to the Government on October 24, 2006 and which contains all principal economic initiatives of MERT for the last year.

The “Comprehensive Plan” lays a special emphasis on tax regulation mechanisms. Actually, the key provision of the document is the support of Russian industrial exporters. It is suggested to stimulate them through accelerating the VAT refund while simultaneously stepping up control over the refund process as well as through improving the mechanism for subsidizing export credit interest rates and the mechanism for granting state guarantees, including to small and medium-sized business enterprises.

On top of that, it is proposed to improve the depreciation policy mechanisms, in particular, to afford taxpayers an opportunity to revalue fixed production assets. It is supposed to considerably increase companies’ depreciation reimbursement. Besides, it is suggested to significantly raise depreciation bonuses from 10 to 20-30% in the event of purchasing high-tech equipment. MERT’s plan also provides for making patenting and leasing operations related to industrial properties as well as research and development operations exempt from VAT.

A separate clause is the introduction of investment agreements. At this stage they are actively used in the Russian automotive industry and give significant preferences to foreign companies with highly localized production. It is worth reminding that this type of relations does not suit well with WTO representatives who treat it as a violation of free trade rules. Supposedly, investment agreements will be introduced in key production sectors of the economy, for example, in the aircraft industry.

To recapitulate, we would like to note that the struggle between MERT and the Ministry of Finance is

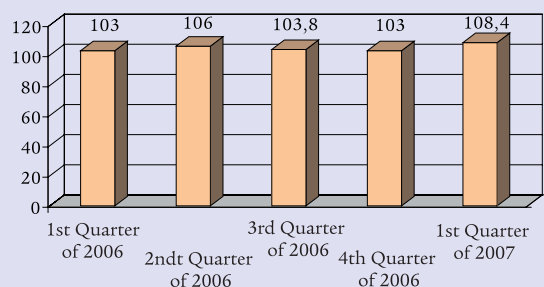
related to both the opposing interests of the Ministers and also different areas of their competence. MERT, responsible for GDP growth and domestic export support, is interested first of all in slowing down the ruble strengthening rate. Therefore considerable state spending plays into German Gref’s hands, for they may reduce the pressure on the national currency. This, however, will result in inflation growth, which is direct responsibility of the Ministry of Finance and the Central Bank. Having said that, given a favourable market situation Alexei Kudrin would benefit from a significant strengthening of the ruble, for in this case the “damaged parties” will be MERT and the Central Bank. The former will get a significant decline in industrial exports, the latter will be accused of domestic currency appreciation.

Competition between the major interest groups represented by the heads of the Ministry of Finance, MERT and Central Bank remains relevant in the first quarter of 2007. The Minister of Finance, whose area of responsibility in addition to the “traditional” inflation rate, now includes the regulation of consumer prices which grew in 2005-2006 at a rather quick pace is now focused on promoting a number of new significant projects. It is first of all, the introduction to the State Duma of a three-year budget with the establishment of non-oil and gas funds (Reserve and Future Generations Funds) being one of its major distinctions. Besides, Head of the Ministry of Finance is trying to block the campaign for reducing taxes in the mid term (VAT, Unified Social Tax, and others), notwithstanding that the project is being lobbied by the key financial and industrial groups controlling a number of core ministries and having strong positions at both the State Duma and the Federation Council.

From the point of view of curbing inflation, the Minister of Finance can be satisfied: increase of prices in the first quarter of 2007 was lower than forecasted by the ministry and consolidated expert’s forecasts. The main reason was fairly reasonable inflation in the sector of services.

The relations between the old strategic allies – Heads of the Ministry of Finance and the Central Bank have undergone serious changes. Beginning with September 2006, activities of CBR were subjected to increasing criticism, mainly due to further strengthening of ruble. The Minister of Finance (in parallel – Chairman of the National Bank Board) was approached with the proposal to launch an inspection of the Central Bank on February 13, 2007 by Head of the Accounts Chamber Sergei Stepashin. Unwilling to risk his own position A. Kudrin agreed to carry out the inspection (later Kudrin handed over this request to Speaker of the State Duma Boris Gryzlov).

Chart 6.8. Industrial Production Index (in % to same period of previous year)



In an attempt to strengthen the position of its ministry, the Minister of Finance is waging an attack on the main financial resources of German Gref – Investment Fund and Federal Target Programs. At the Government, MERT is responsible for economic growth, slowing down the ruble's strengthening rate (support of domestic manufacturers), and, significantly increasing investment. However it will entail an increase in money supply and fuel inflation which cannot satisfy Alexei Kudrin.

Given the above priorities, the results of the social and economic development of the Russian Federation for the 1st quarter of 2007 published by the Federal State Statistics Service (Rosstat) do not look particularly optimistic. The point is that competitiveness of Russian products in foreign markets has become somewhat lower. Particularly in high added-value sectors, besides, the situation in raw material markets (particularly at the beginning of the year) is not very favourable.

Addressing these requiring attention signals, MERT prepared a document – “Forecast of the Socioeconomic Development of the Russian Federation for 2008-2010”. Among other things, it notes growth in manufacturing industries and reorientation of Russia from selling raw materials to the sale of high added-value goods.

6.2.2. Interaction of Authorities and Business

In Russia, the state has three principal mechanisms of influence on the economy – budget planning, tax policy and monetary policy. In 2006-2007, fierce struggle for instruments of influence went on in state administration, which was particularly manifested in the country's primary financial document, it is the state budget.

a) Struggle for the Budget

On December 8, 2006, the Federation Council by a majority vote approved the Russia's budget for the next year. According to this document, Federal Budget revenues are 6 965.3 billion roubles, expenditure – 5 463.5 billion roubles. Domestic Gross Product is expected to grow by 6% in 2007. Inflation is projected

within the range of 6.5-8 percent. The 2007 Budget is based on the average annual price of the Urals oil of 61 dollars per barrel with the exchange rate of the national currency of 26.5 roubles per dollar. The Law on the Budget sets forth the upper limit for Russia's internal debt as of January 1, 2008, in the amount of 1 363 billion roubles, for external debt – 46.7 billion USD.

According to the official figures, state expenditure on the development of all social programs is significantly increased. Expenditure on “Education” and “Health Care and Sports” is up roughly by 37% as compared with 2006 (278 billion roubles and 206 billion roubles respectively). Expenditure under the “National Issues” section will be 808 billion roubles. As regards the defence, the volume of budget appropriations, embedded in the “National Security and Defence of Law” and “” section, is up by 23% on 2006 (822 billion roubles), expenses within the “National Security and Law Enforcement” section will be 662.86 billion roubles (annual growth of 22%). The “National Economy” section will be financed in the amount of 467 billion roubles – a 47-percent growth, expenditure for purposes of the “Housing and Utilities Infrastructure” section will stand at 53.03 billion roubles – a 39-percent growth. Expenditure under the “Culture, Cinematography and the Mass Media” section will be financed in the amount of 68 billion roubles – by 35% more than the year before. 215 billion roubles is reserved for the “Social Policy” section – a 7% increase.

There was fierce inter-ministry fighting for the expenditure items of the country's primary financial document, first of all, between Ministries of the Government and the Duma majority of United Russia. The deputies managed to significantly adjust the budget draft. Characteristic here was an increase in the “social” component of the budget which is important on the eve of the parliamentary campaign of 2008. The lion's share of expenditure is allocated to the implementation of the national projects. In its turn, it will substantially strengthen the positions of the “Gazprom” interest group centred around First deputy prime minister Dmitry Medvedev.

Besides, defence and security expenditure has been markedly increased. It will enable Sergei Ivanov, who is de facto responsible for the key projects in the Military and Industrial Complex, to maintain his resource base. It should also be noted that a considerable part of the funds appropriated to the defence will be utilized by Sergei Chemezov's Rosoboronexport, which will further reinforce the already strong administrative positions of the Head of this institution in the state apparatus.

The price of large-scale state investments in the social sphere and defence is that the projected budgets of the Ministries are reduced. Thus, the Ministries of Transport,

Economic Development and Trade, Culture and Mass Communications, etc. had to come to terms with the reduced financing. German Gref (MERT) also managed to lobby through the allocation of over 11.5 billion roubles to the development of special economic zones.

Meanwhile, already from early 2007, work has been underway on planning key financial indicators for the mid term. On April 13, Duma deputies adopted the third reading of the Draft Law “On Introduction of Amendments to the Budget Code”, which provides for Russia’s change-over to three-year budget planning. This document removes the last limitation on adoption of a three-year budget. Thus, according to its provisions, executive authorities are empowered to form three-year financial plans. Moreover, it becomes binding on the Russian Government to prepare a three-year budget which shall detail the projected macroeconomic indicators for the next three years. These include inflation rate, GDP growth, amount of state receipts and expenditure.

In the three-year budget, the Stabilization Fund will be divided into the Reserve Fund and Future Generations Fund with the Reserve Fund equivalent to 10% of GDP. Nearly all oil-and-gas revenues will be allocated to the Reserve Fund, while “excess” revenues from raw material exports – to the Future Generations Fund. According to the Draft Law, the federal budget surplus in 2008 will be 0.2% of GDP, in 2009 – 0.04%, in 2010 the budget surplus will be zero. Russia’s Nominal GDP of the Russian Federation in 2008 is expected to be around 35 000 billion rub., in 2009 – 39 600 billion, and in 2010 – 44 800 billion rub.

The main work scope during preparation of budget guidelines was to project financial indices, which will serve as the basis for calculating the revenues and expenditure of the federal and consolidated budgets. In this respect, there are two approaches in the government.

A “moderately pessimistic” approach is advocated by senior officials in the Ministry of Finance. They assume that oil prices will go down in the long term from 61.1 doll/bar in 2006 to 55 doll/bar this year and 50 doll/bar in 2010. The stable macroeconomic situation, reduced government debt burden, huge gold and currency reserves will contribute to the continuing favourable investment climate. The paramount factor of economic growth in 2008-2010 – increased in consumer and investment demand. However, domestic demand will grow at a slower rate than in the current year. Deterioration of the situation in world energy markets will result in a lower influx of petrodollars to the Russian Federation, which, in its turn, will reduce the pressure on the national currency, the strengthening of which makes Russian exporters less competitive in foreign markets. Furthermore, a decrease in money supply would result in a smaller inflation rate – the

indicator which is personal responsibility of the Finance Minister. On the whole, the forecast reduction in budget revenues (forecast for 2008 – 6 644.4 billion rub., which in real terms is 6.1% less than in 2007 net of revenues payable to the federal budget in connection with the sale of oil company NK YUKOS’ assets) and energy prices – one of the key arguments of the Ministry of Finance in favour of introducing “non oil-and-gas funds” and cutting government spending.

The Head of MERT’s approach to the forecast of oil prices is more optimistic: German Gref did not agree with the “washing out” of free money from the economy, this leading to a low level of investment in production and a decrease in GDP. Head of MERT was backed on this issue by Prime Minister Mikhail Fradkov who suggested reconsidering the Finance Ministry’s figures which is exactly what happened on April 26 during the Annual Address of Vladimir Putin to the Federal Assembly. Business associations – the Russian Union of Industrialists and Entrepreneurs (RSPP), Delovaya Rossia, and Opora Rossii became other strategic allies of German Gref in his struggle for increasing the projected GDP figures (the two former have already backed the Ministry’s proposals “in exchange” for reducing the tax burden (VAT) in the mid term)

The President called upon the appropriation of 300 billion roubles to the financing of state institutes of development, in particular, to the Bank of Development and the Venture Company. After the allocation of this money, the National Prosperity Fund (as of January 2008) will be 471 billion rub., provided that the average price of Russian oil does not fall below the 55 doll/bar mark. As we see, Head of the State’s initiatives provide for a considerable increase in expenditure part of the budget, which causes higher ruble supply and promotes inflation. Moreover, government investments go into long-term projects (until 2020-2030), which means for Alexei Kudrin a significant growth in consumer price indices in the absence of mechanisms for curbing such trends in the long-term. Head of the Finance Ministry will also have to come to grips with increased financing of numerous social projects which are most likely to be initiated during the canvassing campaign of the “power party” – United Russia. The lobbying of an increase in budget expenditure will become an inalienable part of the process of passing the three-year financial document through the State Duma where the majority is held by United Russia.

b) Strategic Planning: Where is Russia Going?

The Head of MERT – the main opponent of the Finance Ministry in the struggle for the budget – was also involved with strategic projects related to defining the prospects of the Russian economy. Such work culminated in the

presentation of the key scenarios of Russia's development until 2020 at the XI International Economic Forum held in Saint-Petersburg on June 9-10.

Box 6.1. Scenarios of Russia's economic development until 2020

In all scenarios Russia's population shrinks to 138 mln people by 2020, inflation slows down to 3-3.5% after 2010.

The unfavourable – inertia scenario – provides for preserving the export-raw material model, although oil production goes down. Average GDP growth rate in 2011-2020 slows down to 3.3%, trade balance nears zero (planned for 2010): imports – 404 billion doll, while exports – 402 billion dollars. Ruble to dollar rate is 44-45.

The energy-raw materials scenario provides for modernizing the Fuel and Energy Complex (FEC) and transport, the high technology sector grows here and there, annual GDP growth is 5.3%. Trade balance is negative (-28 billion dollars), imports – 530 billion dollars, Ruble to dollar rate is 33-34.

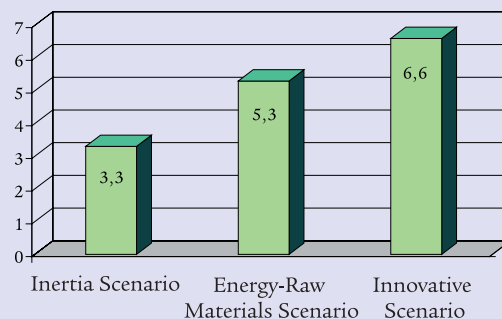
The most favourable scenario is innovative: the cornerstone of the economy is the high-tech sector, annual GDP growth is 6.6%, and imports exceed exports by 72 billion dollars (imports – 578 billion dollars). Ruble to dollar rate is 31-32. The scenarios differ in the level of social spending and investment in infrastructure. In the first scenario, investment in transport totals 2.1% of GDP, only 3000-5000km of new roads will be built, expenditure on research and development (R&D) is within 1% of GDP, on education – 3.8% of GDP, on health care – 4.2% of GDP. In the third scenario investment in transport doubles, expenditure on education and health care grow by 70%, on R&D – four times. The share of the middle class (families with per capita income of at least 46 000 rub. in 2020) reaches 52%, now (per capita income – 20 000 rub.) – 20%.

The innovative scenario whose implementation is favoured by German Gref was publicly supported by Sergei Ivanov. In theory its implementation is least of all in the interest of Alexei Kudrin, since as a result government spending will grow significantly, this leading to inflation growth. Furthermore, even under the most favourable conditions the value of the dollar will markedly increase, this “fuelling” growth of consumer prices. However **at this stage the energy-raw materials scenario appears the most probable**, its implementation may be stimulated by large-scale government investment in infrastructure. They will be realized in two ways: through the Investment Fund of the Russian Federation and through Federal Target Programs – both regional (development of the Far East and Southern regions of Russia) and industry (prepared by JSC Russian Railways, Ministry of Transport, and RAO UES of Russia). It is most likely that the funds provided for in the budget plan will not be enough for the change-over to innovative development.

c) Industry Restructuring

In his Annual Address to the Federal Assembly (on April 26, 2007) Vladimir Putin, among other things, defined the key priorities of economic development, the most

Chart 6.9. GDP Growth under Different Scenarios of Russia's Development (%)



important of which being industry restructuring (change-over to high-tech productions), the implementation of which is expected to be primarily the responsibility of state-run companies. At this stage at the federal level there are three main development projects for high-tech sectors.

The first is to create special innovative development areas, the so-called technology parks (technoparks) (similar projects were designed yet in the 80s of last century). The technoparks were supposed to be based on the science cities of the Soviet type. Today, this project at the Government is promoted by a group of officials from the Ministry of Communications (hereinafter – “communications officials”) led by Leonid Reiman. Currently budgets of different levels provide for 26.3 billion roubles in funds for the technoparks development.

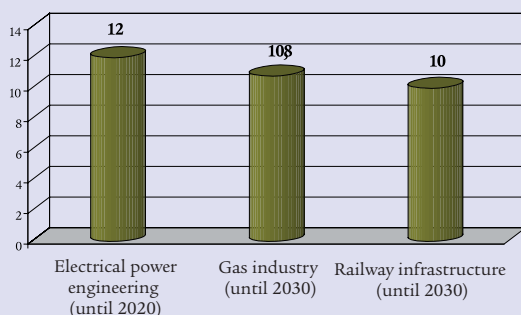
The major agency rival of the “communications officials” is the agency headed by Gref, himself belonging to the so-called “legal experts”. He is actively promoting the special economic zones (SEZ) project, which were initially positioned by the group as an alternative to technoparks. It is worth reminding that the fundamental difference between them lies in different investment stimulation patterns. Thus, the technopark provides significant preferences through collective space lease and joint use of the infrastructure. Whereas the SEZ presupposes, first and foremost, tax concessions. Moreover, neither “communications officials” nor “legal experts” have any intention of giving away their leverage tools in Research & Development to their rivals. Quite instructive is the situation, when prime minister suggested introducing tax benefits at the technoparks but was rebuffed by Reiman, since in this case they would pass to the jurisdiction of MERT.

Apart from SEZ, the “legal experts” are actively lobbying the establishment of state venture funds, to which private companies could later be attracted. Thus, deputy prime minister of the Russian Federation, Alexander Zhukov stated that in the next 2-3 years in Russia it was planned to establish, from the funds of the

Russian Venture Company, 10-15 venture funds with a total capital of around 30 billion roubles. He announced it when speaking at the Congress of the Russian United Industrial Party (ROPP). Over 2006-2007 15 billion roubles will be allocated to these ends. According to MERT's program, the Russian Venture Company will be established with 49% of its investments financed by the state and the remaining 51% formed through private investments. Within two years the volume of investments is expected to be around USD 1.05 billion.

The third federal project is designed to consolidate the financial resources allocated towards the R&D development in the Russian Federation. It is the so-called "high-tech cluster" model. According to the author of the term, M. Porter, the cluster – is a network of suppliers, manufacturers, consumers, elements of industrial infrastructure, research institutes, interrelated in the course of creating the added value. Organizationally, the cluster is closest to the technopark. This project is primarily promoted by AFK Sistema, helmed by its former major shareholder Vladimir Evtushenkov. The company intends to create a new high-tech cluster on the basis of Sitronics – its subsidiary.

Chart 6.10. Long-term investments in strategic industries of the Russian Federation (in trillion roubles)



One of the key factors in enhancing the competitiveness of the Russian economy, according to the federal priorities, is the development of nanotechnologies. On June 9, the Government Nanotechnology Board was set up and deputy prime minister Sergei Ivanov was approved as its Chairman (his deputies on the Board were an easy guess: Minister of Education and Science of the Russian Federation Andrei Fursenko and Director of the Institute of Crystallography of the Russian Academy of Sciences (ICRAS) and of Kurchatov Institute Mikhail Kovalchuk, who, de facto has been for a long time responsible for the development of this industry), and towards the end of the month the Law "On the Russian

Nanotechnology Corporation" (GK Rosnanotekh) was adopted by the State Duma in the second reading. State financing of projects in the area of nanotechnologies, as well as of expenses related to Rosnanotekh's operation, according to the President's Address, will be 130 billion roubles (in 2007 – 30 billion at the expense of redistribution of funds to be transferred to the budget by the Federal Tax Service in connection with bankruptcy of NK YUKOS). However, at the first meeting of the above mentioned Governmental Body, a different figure was announced, i.e. 200 billion roubles.

Rosnanotekh looks like a gigantic non-profit fund subordinated to the Government (control over the corporation will be exercised by the Government pursuant to the corporation's Regulations to be approved by the Government) and almost unrestricted in its activities. According to the current version of the draft law, the corporation will be entitled to engage in any type of business ("or other income generating") activity encouraging the development of nanotechnologies in Russia. In addition, this structure will not fall under the Law on Bankruptcy and its profits may not be seized or distributed. Notwithstanding the fact that in essence Rosnanotekh is integrated in the budget system (thus, the draft law stipulates that GK may be a customer in federal target and other budget-funded programs in the area of nanotechnologies), the Russian Federation and the corporation are not liable for each other's obligations. Rosnanotekh will get the right to both create target capitals (endowment funds) within its own structure and establish other non-profit companies (NPC) on the basis of its own assets, which makes it considerably easier to withdraw funds from the capital of the "nanotechnological" corporation. The only serious restriction for this will be audit of the corporation – it is obligated to be audited as any other OAO (open joint stock company) and the auditor's report is to be mandatorily published.

The speed at which the initiatives (legislative and organizational), required for the "launch" of the priority nanotechnological project, are adopted reflects the strategic importance of high technologies development declared by senior state officials. The expectations are consistent with the scope of anticipated investment: according to MERT's forecast, by 2020 Russia, in value terms, will make twice as much high-tech products as the entire oil and gas sector (their exports will total USD 100 billion a year), which will allow the economy to become more competitive and get off the "oil hook".

However, on closer examination, the nanotechnology project (as it stands now) proves to have no clear end goal. In theory, it is not a unified powerful state structure that is required for its development but a competitive environment of hundreds of scientific groups, otherwise

the USD 7-plus billion – it is the first time in modern Russian history that a sum so huge is appropriated for scientific purposes – may simply “evaporate”. That inappropriate use of funds is very likely to be evidenced, in particular, by a sharp increase in the number of those applying for budget funding of their projects: according to the Centre for Science Development Studies of the Russian Academy of Sciences (CSDS RAS), over the past year and a half, the number of scientific organizations involved in nanotechnologies and operating in the Russian Federation has doubled. Analysis of the US and European experience shows that such phenomenon is quite typical and has nothing to do with growth dynamics of the high-tech sector. It is interesting also to compare the realization scheme for this popular idea. As Andrei Fursenko told the mass media, “speaking of the economy, participation of the state will be minimal. Money will be invested by private business. While the state will help in conducting fundamental research”. Formally the same scheme applies also in the US, but it has one significant distinction: state assistance to nanotechnologies is provided by around a dozen of American institutions and agencies – Ministry of Defence, NASA, etc. Depending on their core activity, these agencies finance in varying amounts different fundamental areas. They are also engaged in putting “finished” scientific designs into practice, while applied research is performed by universities aided by business – venture capital funds, private investors interested in quickly propelling their product into the market. Thus, there is no centralized distribution of funds: scientific groups and even individual students receive grants for their own projects that are implemented using universities’ technological base (for a fee) – experts are allowed to study them anonymously (without knowing the authors) in order to avoid corruption and protectionism. So the Russian economy, in the absence of an industrial base, business players actively operating in the high-tech sphere, and venture investment tradition, should not hold out much hope for overcoming its dependence on “oil and gas” revenues in the mid term. Although, at this stage, this forecast does not look disastrous: there are no objective reasons for a sharp fall in world oil prices so far.

6.2.3. IPOs of Russian Companies in 2006-2007
Russian companies intensified their activity in foreign stock markets in 2005. Until then, share placements had been made mostly by telecommunications companies (Vypelcom, Golden Telecom, MTS) and some oil and gas companies (Sibur). Initially the London Stock Exchange was the platform for Russian issuers. It was due to lower trading floor commissions and relatively mild requirements with respect to Russian companies.

Table 6.1. LARGEST IPOs OF RUSSIAN COMPANIES IN 2006 (in chronological order):

1. Comstar OTS (telecommunications) in February raised USD 1 billion, trading floor – LSE;
2. Razgulyai Group (food industry) in March raised USD 144 million, trading floors – MICEX and RTS;
3. Verofarm (pharmaceutics) in April raised USD 140 million, trading floor – RTS;
4. Magnit (retail trade) in April raised USD 368 million, trading floor – RTS;
5. Cherkizovo Group (food industry) in May raised USD 251 million, trading floors – MICEX, RTS, and LSE;
6. STS Media (Telecommunications, Mass Media) in June raised USD 346 million, trading floor – NASDAQ;
7. Belon (coal mining and processing) in June raised USD 57 million, trading floor – RTS;
8. Rosneft (oil company) in July raised USD 10.4 billion, trading floors – MICEX, RTS and LSE;
9. TMK (metallurgy) in October raised USD 1 billion, trading floors – RTS and LSE;
10. OGK-5 (energy industry) in October raised USD 459 million, trading floors – MICEX and RTS;
11. Sistema-Gals (real estate) in November raised USD 420 million, trading floor – LSE;
12. Chelyabinsk Zinc Plant (metallurgy) in November raised USD 281 million, trading floors – RTS and LSE;
13. SEverstal (metallurgy) in November raised USD 1 billion, trading floor –LSE;
14. Rospadskaya (coking coal mining and production) in November raised USD 316.7 million, trading floors – MICEX and RTS;
15. International Trade Centre (real estate) in December raised USD 105.3 million, trading floor – RTS;
16. RGI International Ltd. (real estate) in December raised 192 million, trading floor – LSE (AIM).

Two years ago came the turn for metallurgical business structures (Evraz and NLMK) to go public in search of considerable funds; they were joined by Russian retail trade (Pyaterochka). However the most expensive IPO was the one conducted by Evgeny Evtushenkov’s AFK Sistema.

Finally, 2006 became a record breaker by the volume of Russian stock offerings in foreign markets: at year-end, Russian issuers managed to raise over USD 17.5 billion.

Let us note that the results of IPOs conducted in 2006 by Russian companies in many ways were unexpected. In 8 of 16 cases, the shares of Russian companies fell towards the end of the first month after the IPO.⁵ The shares of the Pipe Metallurgical Company (TMK) demonstrated the opposite trend – right after the

⁵ The most conspicuous falls – Rospadskaya (-14%), SEverstal (-12%), Verofarm (-9%), Magnit (-8%). Polymetal’s IPOs conducted on February 7, 2007 continued this list – the value of Polymetal’s stock fell at first by 2.5%, then by another 4.24% on the first two days following the IPO. Moreover, the value as of 07.02.2007 was below the offering price (in ruble terms) of Razgulyai Companies’ shares (-15%), Chelyabinsk Zinc Plant (-10%), Rospadskaya (-12%).

offering their value grew by 20% and kept growing to reach 65.45% by 07.02.2007.⁶

As far as the most well known IPO is concerned – “people’s” IPO of oil major Rosneft – here, too, not all went without a hitch. In August 2006, the value of Rosneft shares dropped by 3.2%, but ultimately, towards the end of the first week of February the value of the Company’s shares was up by 20% relative to the offering price.

Thanks to the Russian companies, the LSE became the leader in IPO volume in 2006, raising a total of USD 54.8 billion; the runner-up was the Hong Kong Stock Exchange (main trading floor of Chinese issuers), followed in third by the recent leader – New-York Stock Exchange (NYSE).

The principal competitor of the Russian issuers on international trading floors became shares of companies from developing countries. First of all, it is true of China’s residents. Thus the largest amount of funds was raised through IPOs by: Chinese State Bank ICBC (USD 21.9 billion) and Bank of China (USD 11.2 billion).

The increase in IPOs of companies from developing countries is fraught with complications for Russia’s business structures in the event of their entry into world capital markets in the current year. Considering the competition on the part of developing countries and somewhat oversaturated demand, domestic securities may be valued at a considerable discount.

One of the first signals of non-residents’ declining interest in shares of domestic business structures was the offering of *Sitronics* – AFK Sistema’s subsidiary – in February 2007. “Sister company of AFK Sistema” was priced at the bottom of the range (trading floors – LSE, RTS, MSE (Moscow Stock Exchange) and raised as little as USD 402 million. We could also remember the difficulties encountered by Severstal during its IPO, when investors valued the company below the planned offering price.

Sberbank summed up the results of its public offering in late March. Its SPO (not initial but secondary public offering, since by the time of such offering Sberbank’s shares were already traded in the market) organized by JP Morgan and Credit Suisse became the second public offering by a Russian company after Rosneft. Having sold 2.59m shares, Sberbank raised 230.2 billion roubles (USD 8.8 billion), however did not break Rosneft’s record (USD 10.4 billion) of last summer. Many investors thought the offering price – 89 thousands roubles per share – was too high. 188 companies as well as over 30 thousand individuals – the latter spent 13.7 billion roubles on the

⁶ Other companies’ stock showed the following growth as of 07.02.2007 relative to the offering price (in ruble terms): OGC-5 – 57.9%, Magnit – 48.9%, STS Media – 44.64%, Verofarm – 32.8%, Sistema-Gals – 19.8%, Comstar OTS – 16.7%, Severstal – 1.5%, Cherkizovo Group – 0.6%.

purchase of the bank’s securities – became new shareholders of Sberbank. So, in terms of “people’s” involvement, Sberbank’s IPO remained behind Rosneft’s. Roughly a third of all funds were given by the Central Bank as the principal shareholder of Sberbank. Foreign investors showed a stable interest despite certain technical difficulties related to the local nature of this offering. The result – in the next few years Sberbank will not bother about capital shortage.

Yet the most momentous event of 2007 in the sphere under review remains the IPO of Russia’s second largest bank – VTB, which (IPO) became the largest in the history of the Russian banking system, second in volume next to Rosneft’s, and one of the largest initial public offerings in world history. It was a “people’s” offering to the greatest extent: 131 thousands individuals became shareholders of the bank investing USD 1.5 billion of the USD 8 billion raised by the bank through this IPO. During the market downfall in May, VTB’s securities held their ground better than others, although once during trading they fell below the offering price. Investors will receive 22.5% of VTB’s shares which vows to become one of the top 50 banks in the world in the next 3-5 years and occupy at least 10% of the market in all banking service sectors in Russia.

Apart from that, in the first half of 2007, IPOs were conducted by the largest Magnitogorsk Metallurgical Combine (MMK), Pharmstandard, and PIK Group. MMK’s offering, which was held in Moscow and London at a below market price, raised around USD 1 billion; a leading player of the pharmaceutical industry raised over USD 950 million by offering stock on three trading floors at once (Mices, RTS, LSE) (according to plan up to 40% of all shares was to be floated by the end of June 2007); 15% of the leading developer’s shares were sold during the IPO on the London and Moscow stock exchanges for USD 1.85 billion (the company and its shareholders managed to sell the entire stock meant for sale and to stay within the declared price range, so the IPO results may be recognized as successful).⁷

⁷ Of the largest anticipated flotation’s by Russian companies the flotation’s of Russian banks (Bank of Moscow, Rosbank, Vozrozhdenie, Zenith, Nomos Bank) and energy companies (TGK-1, TGK-4, TGK-5, TGK-7, TGK-8, TGK-9, OGC-1, OGC-2, OGC-3, OGC-4, OGC-6, Kuzbassenergo) should be singled out first of all. It is worth noting that the most relevant problem in the electric power industry is excessive supply. Thus, RAO UES of Russia plans to float securities of a whole number of its “subsidiaries” (OGK-1, OGC-2, OGC-3, OGC-4, OGC-6, TGK-1, TGK-4, TGK-5, TGK-7, TGK-8, TGK-9). As a result, large IPO volumes may prove to be too much for potential investors to swallow. The option of conducting an IPO in 2007 is under consideration by: Vysochaishy (non-ferrous metallurgy), Neolaks (non-ferrous metals industry), SUAL (non-ferrous metals industry), Inprom (network metal service company), Alliance (oil company), Volga Gaz (natural gas production and transportation), Integra (oil service and machine building enterprises), SIBUR Holding (petrochemical industry), Voskresensk Mineral Fertilizers (chemical industry), Kuibyshevazot (chemical industry), RTM Development (real

By the total value of initial offerings Russia took the third place in the world next to the US and China. According to the preliminary figures of Thomson Financial, for the first half of 2007, Russian companies raised USD 15.83 billion. The expected increase in the volume of public offerings is also behind an upward revision of the net capital inflow forecast. The Central Bank has doubled (from USD 35 to USD 70 billion) its net capital inflow forecast for 2007.

However, it should be noted that the popularity of IPOs in Russia is accounted for by political reasons, rather: by entering the global market companies wanted to protect themselves against takeover by the state or at least to register their market value so as to feel safer if pressed into bargaining. In 2006, another distinction of Russian IPOs was noted: according to Rosstat, only 14.7% of funds obtained through the offerings was allocated to capital investment. In the 1st quarter of 2007, the situation looks different: 90% of the IPO volume was attributable to the funds raised directly by the companies and not their shareholders (this figure for the same period of last year was 60%). The new trends hold out hope for a quality improvement of Russian flotations – probably funds will be increasingly invested rather than distributed among shareholders. However, we are not talking about an increase in the number of small and medium flotations. The Russian IPO market is still characterized by one-time but large and very large flotations. With this in mind, it is quite logical that the Central Bank upgraded its capital inflow forecast for 2008-2010 only to USD 40 billion, USD 45 billion, and USD 55 billion – all these figures are greater than previously expected but smaller than in the current year. The deterrents, which may cause some recession during IPOs of Russian companies are, first and foremost, external – such as the somewhat “overheated” stock market in China or expectations of an interest rate increase in the USA.

As can be seen from the industry affiliation of the companies contemplating IPOs, the “raw material” industry is taking a back seat to the banking sector, energy industry, real estate, automotive industry, chemical industry, retail trade, which by and large is a positive sign for the Russian economy. Another thing is that the state is playing a fairly passive role in this process so far and the

estate), AFI Development (real estate), LSP Group (construction), Transaero (freight transportation), Euroset (retail trade), Nutritek (food industry), Pyaterochka (retail trade), Dixie (retail trade), Rosinter (restaurant and café business), ROSNO (insurance company), IBS (IT). On top of that the plans for additional issue of shares were announced by: GAZ (automotive industry), Far East Shipping Company (transport), Open Investments (real estate), RESO-Garantia (insurance), X5 Retail Group N.V. (trade).

Table 6.2. IPO distribution by country (in USD billion)

USA	21,571
CHINA	17,835
RUSSIAN FEDERATION	15,839
GREAT BRITAIN	9,396
BRAZIL	6,905
INDIA	4,268
HONG KONG	3,322
AUSTRALIA	2,936
TURKEY	2,649
SAUDI ARABIA	2,543

Source: Thomson Financial TOP 10 by IPO VOLUME

investment projects financed by the Russian Investment Fund remain just projects.⁸

6.2.4. Potential Strategies of Business Groups in 2007–2008

Over the past two years Russia’s business elite has lived in the anticipation of the 2008 Presidential Elections. Actions of the key interest groups existing in Russia will be largely determined by their outcome. The leading companies have already defied their conduct strategies in the short and long terms, and these trends are most likely to remain relevant through then end of the electoral cycle under review.

Four key Russian business development strategies can be outlined:

- creation of “champion companies”;
- expansion into foreign markets;
- “retention game”;
- sale of assets.

a) Creation of “Champion Companies”

The course towards establishment of large “champion companies” was outlined several years ago and has since been actively supported by the central authorities. Among the most successful business structures developing along these lines should be named: FGUP Rosoboronexport, Gazprom, Rosneft, ALROSA, Norilsk Nickel, (but poten-

⁸ In 2008, the following IPOs are expected – Gazprombank (bank), Uniastrum Bank (bank), Ak Bars (bank), KIT Finance (bank), Investorgbank (bank), Irkutskenergo (electric power energy), VSMPO-Avisma (non-ferrous metallurgy), DON-stroj (real estate), ST Group (real estate) Yuzhkuzbassugol (mining industry), SUEK (mining industry), EuroKhim (chemical industry), OAK (aircraft industry), KAMAZ (automotive industry), Tractor Plants Concern (machine building), United Sovcomflot and Novoship (transport), EMAliance (manufacturer of thermal and nuclear power equipment), Sibirsky Cement (building material industry), Marta Holding (trade), Retail Group (trade), Tehnosila (trade), Kopeika (trade), Victoria (trade), Eurokommerz (factoring company), Compulink (IT), Mass Media System (multimedia company), Corbina Telecom (telecommunications); additional issue of shares – Rosneft (oil company), Seventh Continent/Sedmoi Kontinent (trade), PAVA (food industry).

tially ALROSA+ Norilsk Nickel), Polyus Zoloto, JSC Russian Railways, Russian Aluminium, MTS, and others. This strategy provides for consolidation of the group's assets.

Two types of consolidations may be singled out – vertical and horizontal. The former involves the strengthening and build up of an economic agent's production chain through the purchase of its “intermediary” links. The most common in the Russian Federation is a build-up of the “first” and “last” links. Thus, for instance, having taken control over AvtoVAZ, the Management of Rosoboronexport embarked on vertical consolidation and began ousting SOK – an “alien” group – from the trading structures. As a result, Sergei Chemezov's team managed to obtain access directly to the dealers of its products. Rosoboronexport also pulled off a build-up of the “first” link: it purchased VSMPO-Avisma – a key raw material supplier for Rosoboronexport's enterprises.

Horizontal integration (consolidation) provides for the purchase of direct competitors, which results in a significant expansion of a company's production capacities. Moreover, such strategy may lead to a considerable technological improvement of business structures. The most telling example of horizontal integration is the establishment of Russian Aluminium, for here we deal with a merger of direct competitors.

The main idea of such economic policy – is to accumulate assets on the eve of 2008. They will be needed to implement their own political and economic projects in the next two years.

The course towards consolidation in the strategic industries of the Russian economy is an element of the policy of the Federal authorities aimed at “breeding” large companies with national capital to become leaders in the world market. In other words, we are talking about the creation of the so-called Russian “business champions”.

The drawbacks of this strategy are largely determined by the large resource necessary for its implementation. Thus, for a large-scale consolidation in the strategic area considerable political support is required both at the relevant ministries and in the major federal interest groups.

b) Expansion into Foreign Markets

Expansion into foreign markets is associated with the purchase of assets abroad. As a rule, this strategy is related to the creation of “champion companies”. Here two situations are possible: either the status of a national leader provides the capabilities (financial and image-related resources, support of the federal centre) for expansion into foreign markets, or a successful foreign expansion provides a “carte-blanche” for domestic

expansion. The former is illustrated by the business of Gazprom, JSC Russian Railways, Rosoboronexport, and Russian Aluminium. A classic example of the latter is the business of Severstal, NLMK, Metalloinvest, and Evraz.

The above mentioned development strategy differs from the creation of “champion companies” in that “takeover” (purchase) targets of a business structure are located not in the Russian but in a foreign market. For instance, Gazprom, LUKoil, Severstal, MMK, are implementing projects for expansion into the EU and US markets, Rosneft – into the Asian, Rusal – the African market, Russian Railways operates in the Middle East, etc.

Just as consolidation, expansion may be vertical and horizontal. An example of vertical expansion is Gazprom's attempts to hook up to the “end” user in Italy, Spain, England, Austria, and Germany. We can also remember LUKoil's involvement in Turkmenistan's projects, and others.

The main goal – is to obtain backing at the federal level. This strategy is actively supported and encouraged from “above”, also by president of Russia. It is dynamic economic expansion of Russian companies (particularly in the Fuel and Energy Complex) that should become the main lever of influence for our country in the international arena.

The drawbacks of the expansion strategy lie in the active opposition of local political and business elites in the countries of expansion. Moreover, the implementation of such policy is fraught with rather serious image-related costs and expenses. Apart from that it becomes necessary for a company to have access to considerable financial resources or to have free stock as well as to disclose key financial information on such company's ownership structure, its financial and business activity.

Box 6.2. Expansion of Gazprom

The foreign expansion strategy is traditionally pursued by the interest group centred around Gazprom. Its leaders are Chairman of the Board of Directors of the state monopoly, a potential successor, Dmitry Medvedev and Chairman of the Board Alexei Miller. However Gazprom's foreign expansion goes in parallel with domestic consolidation in the Russian market. Thus, within this process, the gas monopoly is betting on both the vertical and horizontal build-up of assets.

The gas monopoly has already practically “digested” Sibneft and is aggressively increasing production and refining in the Russian Federation. Gazprom also gradually and systematically takes over its principal competitors in the domestic gas market. The monopoly has got hold on a large shareholding in NOVATEK (principal beneficiary of the company – the Chairman of its Board – Leonid Mikhelson) and intends to step up its share in this structure. In addition, Gazprom is implementing a project for purchasing the Russian assets of Itera. Apart from that Miller shows interest in the electric power industry. He initiated the additional issue project for OGC-5.

The gas monopoly demonstrated significant consolidation also in its corporate structure. Worthy of particular mention here are Gazprom Neft and Gazprom Bank. The Management Board of the Bank is run by Andrei Akimov, who has thorny relations with Alexei Miller. Akimov has long been pursuing an independent financial policy, which can not but exasperate the Head of the state-run monopoly. First of all, he significantly increases the borrowings of its business structure, this substantially reducing the financial capabilities of Gazprom itself. In early 2005, the Management of Gazprom Bank submitted to the Board of Directors for consideration an external borrowing program for USD 3 billion. To decrease this amount to USD 650 million, Miller had to agree on a painful compromise: eventually Akimov obtained access to the accounts of all the gas monopoly's subsidiaries. To reduce the clout of the Head of the bank, it was resolved to sell a large shareholding of a subsidiary to Gazfond, which is controlled by the shareholders of Bank Russia.

Consolidation in the domestic market is accompanied by aggressive expansion of Gazprom in foreign markets. Here, one can speak of two lines of business pursued by the gas monopoly – hooking up to the end user in the European Union and implementation of key infrastructure projects.

Gazprom has succeeded in strengthening its position in the EU gas market by implementing two projects in Western Europe. Thus the company made arrangements for gas supplies to Austria. Liberalization led to Austrian companies having to divide different business areas: direct sales and transport. As a result, OMV was left with only gas transportation to handle, whereas sales in the Austrian market came to be the responsibility of three traders, two of which are subsidiary structures of Gazprom. These are GWH and Centrex Europe Energy&Gas. The second project is related to the Russian company's entry into the British market. Its subsidiary – Gazprom Marketing & Trading has contracted 500m m³ of gas to be supplied by Gassco of Norway via the Langede underwater pipeline. Apart from that, in November 2006, Gazprom and ENI signed a Strategic Partnership Agreement, under which Gazprom is allowed to supply Russian gas directly to the Italian market from 2007. The supply volumes will gradually grow up to 3 billion m³ a year by 2010. The Agreement provides for extension of the existing contracts for gas supplies to Italy until 2035. On top of that, there have been numerous negotiations on the purchase by the state-run monopoly of large shareholdings in EU energy companies. Thus there was word that Gazprom has purchased a large shareholding in RWE, Gas Plus, and others.

To support the infrastructure projects of the “Gazprom” group, its representatives in government agencies actively lobbied the construction of alternative ways of energy transportation to Europe. In the summer of 2006, Miller announced the Blue Stream-2 project (South European Pipeline). In this manner, it is suggested to ease off the central direction, dependence on which has often been used to put pressure on Gazprom by transit states. On top of all that, by entering into cooperation with major European companies (ENI, E.ON AG, BASF), “legal experts” get strong allies in the EU. Their main partner within this project will be Germany, which has already been offered a very attractive role of the European distribution centre.

Another example illustrating the development of a business structure according to the “national champion” model is the projects in Russian metallurgy.

The first project for industry consolidation and entry into foreign markets was attempted by Severstal. However, after the derailed merger of the Company with

Arcelor, Mordashov's expansion into the EU territory was called into question. Then Severstal failed to succeed in the intended scenario. Its major rival – Indian concern Mittal Steel – made a more lucrative offer to the Luxemburg company. The main reasons for Alexei Mordashov's failure are believed to have been lack of free financial assets and of lobbying resource at the EU regulatory authorities.

However, in early September Head of Millhouse Evgeny Shvidler announced the establishment of a Evraz-based, largest metallurgical company to be formed through consolidation of large national assets. This project is actively promoted by Roman Abromovich. The Governor of Chukotka, seizing upon favourable business conditions, purchased 41% of EvrazGroup shares.

A similar situation of building the “national champion” exists in non-ferrous metallurgy. Thus, in the aluminium market the world largest company is being formed on the basis of Rusal, Sual and Glencore. As a result of the merger Oleg Deripaska will resolve the raw material issue for Rusal, substantially strengthen his negotiating position in the purchase of foreign assets, and safeguard himself against property claims. Apart from that, the company insists that it is implementing this large foreign economic project in the national interests, and after Mordashov's failure to merge with Arcelor it may become the paramount project in Russia's expansion into foreign markets in metallurgy.

c) “Retention Game”

One of special cases of consolidation is the so-called retention game. This strategy provides for retaining a company's influence and creating protection against hostile actions on the part of its competitors. There are several ways for “seizure” of key assets. The first is economic- consists in purchasing a major stake in a company. The second is political – involves the use of the federal administrative resource. First of all, it is “string pulling” through the General Prosecutor's Office, Federal Tax Service, Federal Customs Service, agencies related to the company's core business. The retention strategy is present in the actions of Mikhail Fridman with respect to Vypelcom; Alfa and Renova – to TNK-BP; Vagit Alikperov – to assets of Komi and the Khany-Mansi Autonomous District; Vladimir Potanin – to Norilsk Nickel.

Key here is the time factor. Thus, if you manage to retain strong positions by 2008, it will be possible to exchange your assets for substantial preferences. Also likely is joining the alliances that will start cropping up in 2007.

If retention occurs in non-strategic spheres, the federal centre does not deliberately get in the way. In other cases, federal authorities do resist it.

The vulnerabilities of such strategy include lack of a legal framework covering property issues. Often times, the main ways of putting pressure on a “non-loyal” business on the part of power groups is the “dubious” circumstances under which such asset was acquired, exchanged or sold during the 1990s. Besides, the federal interest groups keep under strict control the related and “security” agencies which significantly narrows room for action that the businessmen under “attack” can take to protect the asset.

NK LUKoil operates within the retention strategy. Its principal owner Vagit Alekperov is seriously pressured by his political and business opponents: his company is being purposefully ousted from the Russian Federation. In addition, a traditional weakness of this oil company is lack of lobbying capabilities at the federal structures, which made it possible to launch a campaign against it for revocation of its license in Komi and other strategic regions.⁹

d) Sales of Assets

The fourth strategy presupposes sale of assets and often transfer of assets abroad. As a rule, it is associated with the desire to reinsure potential political risks by the interest groups controlling national assets. LUKoil, if anything, may be viewed as a player with such motivation. Besides, Mikhail Fridman’s Alfa is in part working in this direction, or, to be more precise, Altimo which holds the telecommunications business of the Group.

This strategy involves the sale of a portion of a company (stake) to other players. As a rule, it is either a blocking or a controlling stake. There are two ways of doing it: through an IPO or via direct sale to a strategic partner. The former case applies to Rosneft, the energy

subsidiary of RAO (OGK-5), OAK (in the long term). The latter, related to direct sale, applies to Ilim Pulp, NOVATEK.

In most cases, the purpose of sale – is to convert assets to monetary funds, which is due to the uncertainty of political situation and the desire to avoid a possible loss of assets after the elections.

The drawbacks of this project’s implementation – are loss of control over the enterprise, hostile actions related to shareholders’ equity. Another potential risk is a possible conflict with the Federal Centre and shareholders over sale issues.

A classic example of such strategy is the activity of the Head of FGUP Rosoboronexport, Sergei Chemezov. Thus, on November 7, 2006 OJSC VSMPO-Avisma Corporation held an extraordinary general shareholders’ meeting, which approved the transaction for Rosoboronexport to take possession of 66% of its shares. Immediately upon completion of the sale the head of FGUP announced his plans for preparation of an IPO of its titan asset.

A similar situation can be seen in the aircraft industry. In early November 2006, the decision was made at last to establish a Unified Aircraft Building Corporation (OAK). This had been preceded by a fierce battle for the list of companies to become members of OAK. And nevertheless, it became known that immediately after its consolidation, the corporation would go public. It is assumed that at the IPO, 25% of the company’s shares will be sold to top management of the aircraft industry.

As the most important example of sale in 2006, one should mention consolidation of aluminium industry. (SUAL of Victor Vekselberg) and nickel production (Norylski Nikel).

6.3. SUMMARY

Years 2007-2008 will be a decisive period in shaping the composition of forces in the Russian Federation on the eve of parliamentary and presidential elections. Political and economic developments in Russia take a decisive direction towards presidential-oligarchic system of government, where key decisions are taken by semi-formal and informal nomenklatura and political groups, composed of politicians, representatives of big business and state apparatus, including the members of “power” ministries (“silovniks”). The main features of the presidential-oligarchic system, against the background of parliamentary-cabinet system, are presented in Table 6.3.

Feature Parliamentary-cabinet system Presidential-oligarchic system Distribution of power Clear, with the system of *checks and balances* With dominating role of the executive power Decision making centre Government President Parliament’s role Big Small Dominating

⁹ Alfa Group, whose principal shareholder is Mikhail Fridman, also finds itself in a situation of permanent conflicts. It is being pressured on two fronts – raw material (oil and gas) and telecommunications. In the former case its most liquid asset is Alfa’s share in TNK-BP. TNK-BP Ltd was established in 2003. Half of the company is owned by BP, the other half – by Alfa Group and Access Industries consortium and Renova Group. The founders invested in it 96% of TNK’s shares, 98% of Onako’s and Sidanko’s shares, 50% of Slavneft’s shares (50% is held by Gazpromneft), shareholdings in the gas enterprises of Russia Petroleum and Rospan, etc. In 2005, the company’s major assets were transferred to TNK-BP Holding registered in the Tyumen Region. Under the arrangement between the principal shareholders, the moratorium on the sale of the oil company’s shares shall be in effect through the end of 2007, however already now Gazprom is holding Alexei Kudrins on purchasing the interest of NK’s Russian shareholders. In the telecommunications industry, Fridman’s main opponents are Petersburg’s “communications officials”, headed by the Minister of Communications and Information, Leonid Reiman. The latter is actively putting brakes on Vypelcom’s obtaining licenses for a number of business projects (in particular, in the Far East). However, the likelihood that the Minister of Communications will remain in office after 2008 is negligible. Therefore, the Head of Alfa Group is trying to mark time waiting for his rival to leave while at the same time attempting to retain, to the extent possible, the Group’s position in the market.

Table 6.3. Comparison of the main features of parliamentary-cabinet system and presidential-oligarchic system.

Feature	Parliamentary-cabinet system	Presidential-oligarchic system
Distribution of power	Clear, with the system of checks and balances	With dominating role of the executive power
Decision making centre	Government	President
Parliament's role	Big	Small
Dominating influence on decisions	Constitutional bodies (ministries, central offices)	Non-constitutional bodies (presidential administration, oligarchic groups, others)
Decisive components of the political system	Political parties	Political-nomenklatura groups
Decision making mechanism	Formal rules (law and order)	Discretionary
Execution of decisions	Formal procedures	Interventionism
Role of local self-governments	Big	Small
Role of non-governmental organizations	Big	Small

Source: Own analysis.

influence on decisions Constitutional bodies (ministries, central offices) Non-constitutional bodies (presidential administration, oligarchic groups, others) Decisive components of the political system Political parties Political-nomenklatura groups Decision making mechanism Formal rules (law and order) Discretionary Execution of decisions Formal procedures Interventionism Role of local self-governments Big Small Role of non-governmental organizations Big Small

Unusual for a democratic state concentration of power in the hands of the president and his direct entourage is against the classic division of power, weakens the democratic mechanisms and makes the delegation of responsibility untransparent. Proportions between different factors of checks and balances in the system are shaken, which increases the inclination to authoritarian actions and restricts democratic control over the functioning of the executive power. The presidential-oligarchic system started to take shape in Russia (and in other states of former USSR) already in the first half of 1990's, but it developed and strengthened especially during the two terms of the government of President V. Putin. Functioning and development of the presidential-oligarchic system was accompanied in recent years by very favourable economic conditions, inter alia, thanks to a good situation in the markets of oil and raw materials. Maintaining control of rapidly growing receipts from exports of oil, gas and other raw materials has become the main goal for the majority of political-nomenklatura groups.

The review of the situation, presented in this chapter, shows that in Russia we have to deal with very closely intermingled business and political circles. It deforms the structure and directions of stimuli for the

economy and politics, creating conducive conditions for corruption, especially political one, which has become prevalent in the present-day Russia. The system of significant reliance of public administration officials on their superiors and a relatively low level of civil and democratic awareness, which are typical for Russia, facilitate use of economic authority for political purposes and *vice versa*.

The issue of succession after president V. Putin (if he does not decide ultimately to remain at the country's helm by amending the Constitution – which cannot be ruled out until the last moment) will have the key importance for the future composition of power and influence within the Russian elites, but it will have no greater significance for Russia's further development path. Everything indicates that the next president of Russia will continue the model and directions of the policy followed by his predecessor. It seems that in the foreseeable future presidential-oligarchic system with limited democracy will strengthen in Russia. Its internal stability and external predictability will depend in the mid-term on the economic situation, especially on the development of situation in fuel markets. High prices of energy will allow to maintain a high rate of economic growth, and this is expected to provide for comparative public order, at least for some time.

In further perspective, Russia faces serious problems, connected mainly with the necessity to modernize the state and the economy, complement and increase production capacities in key sectors, face unfavourable demographics trends and strengthen law and order. Next years will prove whether Russia will be able to depart from its current model of development based on raw materials and fuels and build a modern state, even if its basic solutions will differ from European examples.

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