

Russia in 2012: Forces for Change



2012



Content

3	Preface
5	The Russian Economy
9	Accession to the World Trade Organization (WTO)
12	Privatisation
13	Health and Safety and The Upgrade of Russian Infrastructure
15	Domestic Politics
27	Russia on Trial
30	Conclusion

Cover: President Medvedev casts his vote in the Duma elections on 4th December 2011 (*PHOTO: Agency photo ITAR-TASS*)
Cover inside: Meeting organised by opposition group "For honest elections" on Prospect Sakharova, 26 December 2011
(*PHOTO: Agency photo ITAR-TASS*)

Preface

In Russia, December was by far the most eventful month of 2011. United Russia's poor showing in the December 4th parliamentary elections and the street demonstrations that followed undoubtedly sent a jolt to the leadership, and the demonstrators may be able to claim at least one high level scalp for their cold afternoons spent on the streets. The departure of Vladislav Surkov in the last days of 2011 suggests that Vladimir Putin feels a need to urgently reinvigorate his appeal – even to campaign for the presidency, for which he confirmed his candidacy in September. Although Putin's election in March 2012 seems assured and we do not foresee a "Russian Spring", some of the complacency of the Putin/Medvedev administration may disappear from Russian politics, at least for a while.

Russia stood at the side of the major world events of 2011; events that one way or another will shape the future, including Russia's future, much as Russia sometimes seems set on pursuing its own course, as if the rest of the world were not there. Amongst them are the so-called "Arab Spring", tensions around the nuclear developments in Iran, uncertainty about the future of the EU and of the euro, the expected second wave of the world's economic crisis and, of course, global recession, which some say is here with us already. The 2012 presidential elections in the USA, France and some other countries, including indeed Russia, also started to have a play in the international arena in 2011. These destabilising events make forecasting a very dicey business. It is no wonder that the leading lights in that game should try to outdo each other in painting doomsday scenarios. If such outcomes do not materialise, their predictions will be happily forgotten. If they do – how gratifying for them at least to be hailed a true prophet.

Against the background of these world events, Russia in 2011 has been quietly pursuing its own agenda without making any prominent forays onto the world stage. The Prime Minister, Vladimir Putin, was briefly outspoken in relation to the Anglo/French-led Libya campaign but his abusive remarks were nicely tempered by the President, who also ensured there was some pleasant diplomatic warmth on the occasion of the British Prime Minister's visit. Russia has been pursuing its own petro-foreign policy with the Ukraine and with Belarus, but has stayed out of the mainstream of European debates largely because it is able to. On Syria, Russian foreign policy has been a nuisance so far as most of the rest of the world's attempts to intervene are concerned. Domestically, we saw little change; no major new initiatives and few projects coming to fruition – indeed much less about the "modernisation agenda" than we heard before. We even thought that the announcement of Putin's candidature for President would draw a line under what was Russia's only political storyline, but, to our relief in terms of material for our review of the year, it gave rise to a new one.

Apart from the protests, there have been rather few major stories with which to punctuate our review of the year. We had tragedy indeed but, mercifully, no major terrorist incidents, no sensational sackings (although we saw the Finance Minister resign and



The uncertainty over whether Putin would return as President in 2012 was resolved on 24 September – for many, there had been no uncertainty (PHOTO: Agency photo ITAR-TASS)

Surkov moved out), no drought and, up to New Year at least, not even much snow, as we experienced the warmest December for 130 years.

So, from the point of view of compiling our annual review for 2011, the elections and public protests that came in December were like a goal in extra time. Previous editions of this review have already mentioned the lack of love for the state, the simmering dissatisfaction among some sections of the population and the increasing visibility of opposition groups. But the public and very vocal protest against, not just the Kremlin generally, but against Putin personally that seems to have been triggered by Putin's announcement of his candidature and by the Duma election process, takes this discontent to a new more vocal level. In our view, since Putin's candidature was not unexpected, the protests were the key political story of 2011.

The views expressed here are inevitably the personal views of the authors based on largely secondary sources and describes now we see the state of affairs in Russia as at 31 December 2011. As might be expected, our colleagues at CMS hold a range of personal views on the various political and economic issues affecting Russia. However, we have at least a consensus among a peer group of Russians and expats that the opinions set out here are informed and reasonably objective. Regarding any forward looking statements, however, in the uncertainty of these times, no reliance should be placed on such and we accept no responsibility whatsoever.

The Russian Economy

Budgetary Policy and Issues

The budgetary policy for the period 2011 – 2013 that was adopted in 2010 set out the key strategic targets for the country's development in terms of restoring the macroeconomic balance by reducing the country's budgetary dependence on exports of hydrocarbons and by a gradual reduction of budgetary deficits. The Government had forecasted in 2010 that the Russian economy in the next several years would function in an environment of comparatively favourable conditions as regards world commodity and capital markets. The projected price of Urals oil, for example, was USD 75/bbl in 2011 and USD 79/bbl in 2013. The forecasted 2011 level of inflation was between 5.5% and 6.5% per annum; GDP growth in 2011 was 3.4%; growth in industrial production was 3.2%; and growth in capital investment was 8.8%. This was expected to result in the growth of disposable income of the population, increase in investment in natural monopolies, improvement of liquidity in the interbank market and so on.

Many of the forecasted figures proved to be close to reality or even too modest. GDP growth in 2011 was 4.1% exceeding the forecast and oil prices kept well above the expected levels throughout the year, resulting in surpluses that must be the envy of "western economies". The year-end Ministry of Economic Development predictions are for inflation at 6.2%, which would be the lowest for the last decade and 5-6% in 2012.

A number of factors were responsible for lowering the inflation levels, including the good harvest in contrast to the previous year, when agriculture was blighted by drought and fire. Also the traditional end-of-year rise in inflation did not materialise this time. At the same time, many experts believe price increases have been held back by (and so are a symptom of) very high capital outflows, which is not a cause for rejoicing. Others believe that prices have been artificially kept down as a political manoeuvre and that no significant price rises should be expected before the presidential elections in March. As a sign that this might be true, the customary utilities and other natural monopolies-tariff increases were shifted from January, which would be normal, to July 2012.

On 18 November, the State Duma voted for the 2012 – 2014 budget. What was notable was how defence- and law-and-order-related spending is budgeted to increase significantly, while provision for health and education are to be squeezed, never mind the election. Amongst other things, the Parliament voted as well for the Government's proposed amendment that gives the cabinet flexibility to reallocate up to RUB 200 billion (circa USD 6.45 billion) between budget items. In other words, the Government will get USD 6.45 billion, which it can spend at its own discretion without further parliamentary scrutiny or approval. This practice of releasing billions of dollars into "operational management" started in 2009, the crisis year, and was justified at that time as an expedience to solve acute problems threatening economic and social conditions (and avoid civil unrest?). Now it seems to be becoming less of an expedience and more of a fixed part of the annual budget process bringing a material part of the economy under the

manual control of the Government. As we observed in a previous Review, not all commentators in 2009 bought into the Kremlin's allocation of substantial state funds toward propping up inefficient state-owned industries (and more recently, the massive bail-out of the Bank of Moscow), but this will likely remain government policy, particularly as civil discontent is already on the increase and as the Prime Minister and the President have been enthusiastic proponents of the policy.

The increase of state spending through manual control policies returned to life (albeit on life support) some significant regional employers and made the lives of pensioners and employees of government-financed organisations somewhat easier, but did so at the price of a much extended budget and a heavier tax burden on the entire economy. This fell heavily at the feet of the item Finance Minister, Alexey Kudrin who was given assignments amounting to several trillions of roubles that were hardly affordable despite the presence of the Reserve Fund and the beneficial oil price. Mr. Kudrin had to search for additional sources of income resulting in increased taxation of the oil and gas industries as well as a hike in excise duties and social security contributions by employers and increased heavy-handedness on the part of law enforcement, tax and other authorities. All of this has led to a more difficult business climate. One of the direct outcomes of manual control policies was the fuel shortage in mid-2011 that hit not only the regions, but Moscow as well. It was caused by oil firms being instructed to keep domestic petrol prices down and then the sudden "planned" closure of several refineries. More crude went for export and less was left to be refined into petrol and diesel for domestic consumption. In more general terms, Russia through 2010 and 2011 factually became much more dependent on the oil price than it was at the beginning of 2008 and all of this took place under the slogan of "modernisation" and deliverance from such dependence that was a theme of our last review.

It must be noted that the result could have been even more dramatic if the enthusiasm of the top executives had not been tempered by the active resistance of the Finance Minister who was finally forced into resignation for his discord. Now his restraint on the executive is there no more. The weekly publication "Kommersant Dengi" did some "pre-election arithmetic" and came to a conclusion that what was in effect the ruling party's election campaign turned out to be a show of unprecedented state largesse. Up to RUB 50 trillion (circa USD 1.6 trillion) has been promised to the population of Russia in the form of "guarantees" and "pledges" during the last year and a half. This amounts to several annual federal budgets. The same publication also analyses the budgetary expenditure planned for 2012 – 2020, which it puts at approximately RUB 200 trillion, of which around 80% (RUB 160 trillion) will be spent on social welfare, defence and law and order. The remaining 20% should somehow cover the rest – economic development, culture, science and education together with modernisation and innovation of the economy.

Looking at these figures, the chance that Russia will manage to rid itself of its reliance on hydrocarbons exports in the near future looks quite slim. Bloomberg reports that in



Russia intends to start taxing “luxury consumption”, but it is not clear how this will be defined. Rather like the elephant: we know it when we see it, but we cannot say what it is.

2010, crude oil production reached its highest level since the disappearance of the USSR (10.15 million bbl per day), and Russia retained its leading position in oil extraction that it attained in 2009. The revenue from exports of crude oil and various oil products in 2009 was USD 178.233 billion and was USD 39.38 billion from natural gas.

As a measure of the general mood perhaps, the net capital outflow according to the Central Bank was USD 38.3 billion in 2010, and will reach almost USD 90 billion in 2011. If 2010 was a year of recovery from the crisis, 2011 seems to have been a year of uncertainty and new crisis expectations.

Despite the flag-waving of the modernisation agenda, with a total volume of high technology exports of 1.6% in 2007 in absolute terms Russia is in the same league as India, Portugal and Slovakia regarding exports of high technology products. South Korea exports 14 times more high technology products than Russia does, while in the case of China and the USA, it is as much as 42 times more. Overall, Russia’s share of global trade in high technology is only about 0.3%.

This insignificant share of high technology is the result of reliance on exports of raw materials or products with a low degree of processing as well as the low competitiveness of Russian enterprises in the global market. For comparison purposes, the share of high technology for Chinese exports is 28.2% and 26.1% for the USA.

Monetary Policy and Macroeconomic Indicators

In its recent announcement, the Central Bank left the refinancing rate unchanged at 8.25% per annum, which was in line with market expectations. The previous 0.25% increase had taken place in May of 2011 after another 0.75% increase in February. The Central Bank took the recent decision to leave the rate unchanged based on inflation dynamics (6.9% at the end of September, i.e. below the forecasted 7%) and to mitigate the risks to sustainable economic growth. The decrease in the rate of inflation is mainly influenced by food price fluctuations and the positive effect of this is gradually deteriorating. Price reduction is also observed in the services industry (and not least the law!). On the other hand, prices for industrial goods have remained high for a number of months already.

The dynamics of other macroeconomic indicators are multidirectional. The industrial production index dropped while the rate of capital investment increased after it had slowed down in the third quarter of 2011. The unemployment rate remains comparatively low. The official statistics show growth in disposable household income and an increase in consumer credit activities. However, in reality the income disparity between different social strata remains dangerously high.

Fiscal Policy and Allocation of Budgetary Expenditure

Much heated discussion takes place about what the Government will really be able to afford after the elections and what it will not. The Prime Minister has already pledged not to increase the rate of income tax on individuals (currently at a flat rate of 13%), but was adamant that it will be necessary to tax "luxury consumption", while being characteristically non-specific about what will constitute "luxury consumption".

The Finance Minister announced recently at a conference on taxation that there is enough money and taxes will not be raised. However, the Chairman of Sberbank, German Gref, who was Minister of Economics and Trade from May 2000 to September 2007 and is now president of Sberbank, wanted to know how the Government's commitments to pensioners and other "pledges" will be financed if taxes are not raised. One way would be by reducing the RUB 20 trillion rearmament programme, but it is exactly for his refusal to support this programme that the previous Finance Minister lost his position. This event showed how far the current President was prepared to go to defend the plans. This is not an aberration on the President's part, however. The reason is not so much Dmitry Medvedev's eagerness to provide the army with cutting edge weaponry, but rather the belief that through defence expenditure it will be possible to stimulate economic growth and modernisation, finally achieving deliverance from the dependence on oil and gas exports. This is of course a policy that Russia has pursued enthusiastically once before and, although defence spending can in theory stimulate other sectors of the economy and thus create economic growth, one should not forget how the economy of the Soviet Union was finally buried by the arms race, sucking out of the rest of the economy the lion's share of labour and other resources and rendering

post-Soviet Russia, in terms of a home-grown technology base for consumer products, nowhere to be seen.

The IMF predicts that in 2012, the growth of GDP in Russia will fall from the 2011 level of 4.1% to 3.5%. This is the most pessimistic of forecasts among those provided by a number of international institutions. Others more optimistically predict GDP growth in the range 3.9% – 4.1%. The IMF notes that the economy of Russia in general recovered from the 2008 – 2009 economic crisis, but the perspectives for future growth are threatened by the crisis in the EU and in particular from the expected drop in demand for oil and ensuing reduction of oil prices that will impact Russia's exports of hydrocarbons and cause revenue erosion. External financing of the banking sector will likely also further diminish, in which case a recession in Russia is quite probable. However, in the opinion of the IMF's experts, the downturn of the economy of Russia will not be as dramatic as it was in 2009 when GDP reduced by fully 7.8%. The reason is that in 2008 – 2009 the economy was already overheated so that the downturn was relatively more serious. Now the economy is more balanced, but, on the other hand, Russia is now financially less prepared than it was in 2008. In the light of these prognoses, the IMF recommends that Russia rebuilds its reserves, but this will of course require a tightening of the budgetary policy by reducing subsidies and tax benefits. Statistics show that active re-building of reserves is taking place already, but tightening of budgetary policy is another matter altogether and in this respect, in practice Russia seems set on the opposite course.

Accession to the World Trade Organisation (WTO)

A question that has become more topical during 2011 is whether Russia's long overdue accession to the WTO after 18 years of vacillation will impact growth, diversification or other aspects of the domestic economy. Russia's accession will take place in the middle of 2012. The Prime Minister and likely next President, Vladimir Putin, seems never to have been particularly enthusiastic about WTO membership. In his opinion the advantages and disadvantages for Russia are somewhat equal and his personal attitude seems to have swayed from apathetic to hostile. Significant progress was made in the early 2000's such that Russia seemed ready to be signed up by around 2002, but into Putin's second term, the Government's policy significantly hardened. The period was characterised by significant protectionist policies, in favour of the domestic car and aviation industry for example. In this regard, government policy seemed to fall into step with some oligarchical interests, in which case they seem to have used the interval to prepare themselves for accession, and this could have something to do with the timing.

WTO accession undoubtedly sends a positive signal to foreign investors as evidenced by the reaction of all western leaders, the IMF, rating agencies and the World Bank. Of course, the lowering of import tariffs on a range of European exports, at least in the long term, is seen as very good news for European producers in the present times of

crisis and tight domestic consumer markets. More positively, WTO membership is seen to mean more transparency and accountability of the Russian Government on trade issues and a safeguard against an unexpected return to protectionist policies, including at the behest of certain state “insiders” – an obvious risk to foreign investment. Indeed, Russia has already been taking account of WTO policies as can be seen, for example, in development over a number of years of the intellectual property legal framework and the amendments to the technical standards regulations.

Discriminatory import tariffs persist, however, in a wide range of sectors and this will be the fundamental change affecting Russian imports following WTO accession, although the effect will not be immediate owing the grace periods that apply. Of note is the fact that Russia managed to negotiate much more favourable conditions than it could have hoped for such that, for example, many limits on import duties are set not very far below where they are at present – generally WTO membership will mean only a 3% reduction in import duties during a seven-year transition period. Only in selected, most cherished areas, like imports of automobiles, are import duties supposed to drop materially (from 30% to 15%) during this seven-year transition period. These are substantially better terms than were offered by the WTO previously.

The widespread notion that the reduction of import duties will put local producers under some new risk of competition from foreign imports, is however a myth. Given the good deal and long transitional period that Russian negotiators have achieved, WTO accession might actually be less significant for Russia’s domestic economy than fluctuations in the exchange rate. In reality, for more than a decade Russian producers have been hit by the super-high oil prices that prop up the rouble. This in turn makes imports cheaper and already fuels the fast growing volume of foreign goods penetrating the Russian market and will continue to do so with or without WTO accession. During the 11 months of 2011, for example, the effective rate of the rouble against the currencies of its main trading partners grew by 4.8% compared to the same period in the previous year. That is equivalent to the reduction of import duties by about 5% in one year. To illustrate the reality of this, from 1999 to 2011 while Russia was not in the WTO, the turnover of international trade grew 7 times in nominal dollar values, reaching an historic high of more than USD 800 billion in 2011. Russian exports in the same period grew 6.5 times (mostly explained by the growth in oil and gas prices) while the volume of imports grew 8 times.

In those sectors where at this time competition is almost completely absent, like in telcoms, banking and insurance, the interests of Russian business groups are very safely protected by the conditions incorporated into the agreements reached with the WTO (so that the Russian consumer is not). Quota limits in the financial services space have operated in Russia and continue in the case of insurance where currently a maximum of 25% of the total market for domestic insurance may be held by foreign investors¹. Similar restrictions on the total amount of foreign bank capital can be imposed by federal

¹ Federal Law No. 4015-1 “On Organisation of Insurance Business in the Russian Federation” dated 27 November 1992.



After 18 years of negotiations, Russia got itself a good deal and its accession to the WTO will take place in the middle of 2012. (PHOTO: Agency photo ITAR-TASS)

law, although the current policy of the Central Bank is not to impose such limits. WTO quota limits for both banking and insurance are set at 50% so that this will have some effect on insurance but make little difference to banking. Restrictions on the establishment of branches by foreign banks will remain. In the case of insurance companies, the restrictions on branches will remain for nine years.

As far as exports of Russian goods are concerned, accession to the WTO is supposed to remove or at least lower the existing barriers. This is likely to be significant in the case of metals, chemicals and agricultural products where Russia currently faces barriers from being outside the WTO. In the mainstream consumer products and high technology sectors the removal of barriers to Russian exports is likely to be less of an issue than the problem of finding a market for them. The traditional export staples of oil and gas and armaments are outside the scope of the WTO treaties.

The export of Russian agricultural products, mostly grain, has grown rapidly in recent years and might have a good chance to win from WTO accession – particularly taking into consideration that Russia managed to negotiate the right to subsidise agriculture even more than it does now (from 3.5 billion roubles p.a. to 9 billion). However, since the scope for subsidy was hardly used before WTO membership, it is not clear that it will be exploited more fully afterwards.

As we reflected in our Review of 2009, Russia's journey toward WTO membership has been extraordinary and marked by periodic reversals of policy – such as the creation of

a three-way customs union with Kazakhstan and Belarus just at the point that accession seemed to be assured. Overall the accession of Russia to the WTO should be more profitable to it than remaining outside of the organisation particularly given the terms it has negotiated. We would like to think that the fact of the accession symbolises Russia's agreement with the simple notion that walking together with the rest of the world is indeed better than always walking alone aslant its path – but we are not too sure about that.

Privatisation

The Government's privatisation policy was announced at least two years ago and was expected to run during the course of 2011 to 2013 with a total value of USD 33 billion but it became clear during 2011 that it will in reality spread over a longer period. Amendments to the list of assets were presented in August 2011 adding thirteen more government-held stakes that are to be sold, after the President announced in June that he considered the sell-off plans too modest. The list includes the leading companies in various sectors of the economy. Despite a slow and delayed start, the process did commence with the sale of 10% in the country's second largest bank, VTB, raising USD 3.3 billion in February 2011 in what was regarded as a satisfactory rather than brilliant start. In the original plans for privatisation, it was notable that in virtually all significant cases, only minority participations were to be offered – for example, 25%-1 in Rosneft; 7.97%-1 in RusHydro; 7.58%-1 in Sberbank; 35.5%-1 in VTB; and 25%-1 in RZD (Russian Railways). During 2011 smaller stakes were being discussed and "golden share" structures began to appear within some of the detailed proposals although this seems to come from the companies' own management and reflect market conditions rather than a hardening of government policy, which could indeed be more ambitious. For example, under the original plans, the Government was offering to withdraw totally from United Grain Company offering 100% for privatisation, but now it plans to retain a controlling stake. On the other hand, while original proposals envisaged a sale of 35.5%-1 in VTB, there are reports that the Government will ultimately dispose of its entire 75.5% and shipping company Sovkomflot, Moscow's Sheremetyevo airport, and oil firm Zarubezhneft are on the list for 100% privatisation.

Given the generally small stakes that were originally to be offered in the most attractive assets and the tendency to add veto rights and golden shares into the package as the detail is worked through, it may be that the programme is driven by the need to plug budget deficits and fund the renewal of the country's infrastructure rather than by any political aspiration toward widespread privatisation of the economy but it is difficult to determine this. The timing of the programme has in any case been substantially impacted by the global financial crisis and the quite reasonable assessment that market conditions are not favourable for an ambitious sell-off according to the original timeframe. For example, Sberbank planned the sale of a 7.6 percent slice in September 2011 but this was postponed after turbulence on global markets wiped around \$1.5 billion off the stake's value. However, the "wait and see" policy is coming under pressure as the

state finds itself increasingly in need of funds and for this reason it is expected that the programme will gather pace in 2012.

Health and Safety and the Upgrade of Russian Infrastructure

Replacement of soviet-era infrastructure, buildings and technology is now on the agenda and, with the prospect of recession forcing the Government to spend on infrastructure, many see this as a growth sector in 2012 although everything depends on the availability and extent of public financing and the delay of the Privatisation programme might affect this. A number of significant projects have already been initiated and the respective tenders launched, including the Western High-Speed Diameter road, Neva Water BOT² and the Palace of Arts projects in St. Petersburg, the Kuromoch airport privatisation project in Samara and the M4 Federal Highway toll operation project. The Perm western by-pass project is still in a developmental stage but expected to launch in the period 2013 – 2014. There is also a healthy pipeline of upcoming projects down the line, mostly in the transport, housing services and utilities, solid domestic waste and energy efficiency sectors. Investors will have their eyes set on infrastructure projects related to the 2018 FIFA World Cup to be held in Russia; the announcements for these projects are expected soon.

As an example of this on a more domestic level, under a housing development project announced in 2009³, the Moscow city administration is to demolish some 413 buildings that have been declared unfit for habitation and commence the repair and refurbishment of others. These buildings are mainly those that were constructed during the housing programmes in the period 1958 – 1973 and include the so-called “khrushchevki”, which are 5-storey housing blocks built quickly and cheaply during Nikita Khrushchev's time as part of the “Housing Revolution” that followed the XX Party Congress of the Communist Party of the Soviet Union and provided new housing for around 54 million citizens, nearly a quarter of the population, of the USSR. During the period 2012 to 2016 (i.e. commencing now), the Moscow Government has announced that it will be spending RUB 1,885,573,100 (circa EUR 47 million) on this programme⁴, which does not seem a massive amount in view of the scale of the problem.

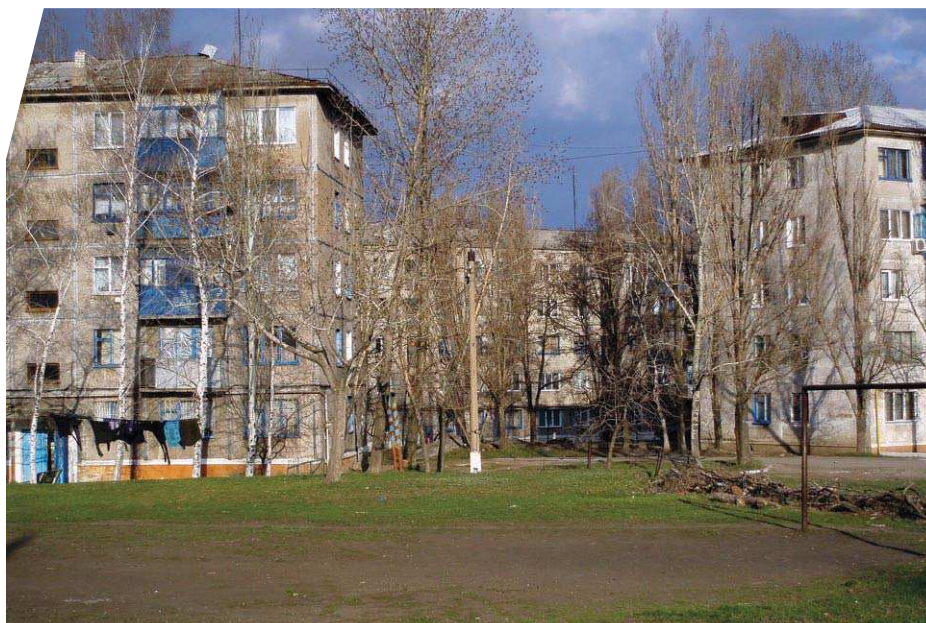
Pressure to overhaul outdated technology was increased by a number of serious accidents that occurred in 2011, which drew attention to the widespread failure to decommission old technology. Soviet-built civil aircraft particularly came under the spotlight.

One of the most tragic incidents in 2011, in terms of its widely felt impact, occurred on 7 September, when a Russian Yak-42 airliner crashed near Yaroslavl, resulting in the loss of all but one life. The plane was chartered and the passengers included virtually the entire Lokomotiv ice hockey team as well as the coaches; so this was a national tragedy of

² A project for the construction and operation of new water treatment infrastructure.

³ N 462-ПП “О проекте размещения жилищного и других видах строительства в городе Москве на период 2011-2015 гг.”

⁴ See note 3.



Few will lament the removal of the “khrushchevki”, but they gave Moscow a particular architectural identity and it is doubtful that very much of that identity will be preserved in the buildings that replace them – so take a long look now.

some magnitude in view of Lokomotiv’s prominence in the Continental Hockey League (“KHL”). The crash occurred when the plane failed to gain sufficient altitude after take-off and crashed just 500 metres from the runway.

The Yaroslavl crash was not an isolated air disaster. Whereas the national carrier, Aeroflot, has a sound reputation, trust in Russia’s regional airlines has evaporated following a run of 36 fatal passenger events since 1990 involving airliners from Russia and other countries of the former Soviet Union⁵. On 23 June 2011 President Medvedev requested that Russia’s Ministry of Transport review the possibility of phasing out the Tu-134 from regular flights by 2012, putting huge pressure on the regional airlines. Air crashes usually result from the combination of a number of factors – technical and human – so that although the age and servicing of these soviet-era aircraft cannot not be ignored, the crash investigations seem to place most emphasis on flight safety standards as was picked up by the Interstate Aviation Committee that in November recommended that the Russian Government adopt international (ICAO) safety standards on all routes operated by Russian airlines, including domestic flights – making the seemingly rather obvious point that the safety standards should be the same on both international and domestic flights. The fragmentation of the domestic airline operators has also been identified as a factor leading to inadequate technical and management competence and the IAC has recommended a major consolidation programme to enlarge regional airlines

⁵ Airsafe.com LLC (www.airsafe.com)

by merging the smaller independents to eliminate those technical staff and management personnel of airline companies whose qualifications fall below the requirements of the industry and who have committed previous safety or security violations.

From the point of view of the casual observer experiencing daily life in modern Russia, the Interstate Aviation Committee report seems to get to the nub of it. In Russia, private operators are frequently negligent in their regard to public safety, lack resources to maintain equipment, lack necessary competencies and are inadequately inspected by the relevant authorities. In another national tragedy that occurred on 10 July 2011, the leisure cruiser Bulgaria capsized on the Volga River, with the loss of 122 lives⁶, sinking within the space of just four minutes shortly after embarkation. Mechanical malfunction was blamed but the vessel was built in 1955, when it had been designed to carry 120 – 140 passengers. It had been modified in order to be able to accommodate up to 259 passengers and was fully laden when it sank. According to reports, the cruiser had been allowed to embark notwithstanding a visible list to the port side where portholes below deck were left open. There was also a malfunctioning starboard engine. Although the prosecution of the tour operator was unsuccessful and that against the owner is still pending (so their own innocence must be assumed), this was one incident among thousands of others that occur every year, that had all the hallmarks of an accident that could have been avoided if Russia committed to a culture of “safety first”.

As a clear step in the right direction, and in response particularly to major industrial accidents such as the explosions at the Rapadskaya coal mine in 2010 and at the Sayano-Shushenskaya hydro-electric power station in 2009, the Government has enacted new legislation (in force from 1 January 2012) that requires owners of all “hazardous facilities” to insure against their civil liability. The obligation to effect insurance should be a preventive measure, incentivising operators of such facilities to make safe, if only to obtain such insurance and/or reduce premiums⁷.

Domestic Politics

The Presidential Election

2011 took us into the lead up to the 2012 elections that take place early next March. The 2008 presidential elections were preceded by anticipation that a change of leader would be de-stabilising, and, at that time, we saw a short-term dip in foreign inward investment activity as a result of uncertainty about the outcome of the elections. At that time it was the prospect of Russia without Putin that was the overriding anxiety of international observers. However, it soon became clear that the *status quo* would be unaffected by the change of leader, that Putin would not be far away from the helm and, indeed, that the new leader was displaying a number of positive tendencies. Investment activity revived quickly.

⁶ Out of a total of 208 passengers – source: Kommersant.ru (27.12.2011).

⁷ The Law on compulsory liability insurance for owners of hazardous facilities for harm caused by an accident at a hazardous facility: №225-ФЗ of 27 July 2010. Discussion of the new legislation is set out in the CMS Legal Briefing of 22 December 2011.

From around August of 2011, there seemed to be a similar dip in inward investment activity, although in the climate of the global crisis it is more difficult to be sure if this was because of anything as specific as uncertainty about a change of administration in Russia. On one analysis, the ruling tandem of Putin and Medvedev is just that, a ruling tandem; and so it should not matter very much which way round it is from one presidential term to the next. However, as we reported in our 2011 Review, there is a sense that Medvedev has provided a welcome, more modernist, even more liberal⁸, respite from Putin's autocratic and statist style and so, even if a Putin presidency is widely assumed, some apprehension remains about what it means if the respite is over and what style of president Putin will be next time around.

Assessments of Medvedev are obviously divided but negative perceptions derive mainly from the fact that, despite much talk, he has in practice made little headway in reducing bureaucracy and corruption in Russia although, in a little bit of (relatively) good news, Russia did improve its ranking in the much-quoted World Bank "Doing Business" Report – from 124th in 2011 to 120th in 2012. His much more personable style and his enthusiastic focus on modernisation, on the other hand, has won him a real international constituency, particularly with the USA.

In recent years, while the ruling tandem has been perceived to be, in a sense, the wrong way round, the only real political topics for debate have been whether Dmitry Medvedev is a president in his own right and whether there is any political difference between him and Putin. With the announcement that Putin will indeed seek a third term of office and that Medvedev will, in that case, swap places to become his Prime Minister, the reality has emerged that, in answer to the first question, Medvedev is not a president in his own right, but was and remains a political appointment of Putin's. The second part of the question, whether a Putin administration will see Russia turn away from Medvedev's focus on technology and innovation, as well as a return to more authoritarian political language, is a matter of speculation, but the truth so far as concerns economic modernisation, is probably not, and indeed accession to the WTO should provide some protection against this. What some do fear, however, is a slowing of the pace of "modernisation" or even stagnation from a third-time-around leader who is visibly less excited by and conversant with technology and ambivalent toward democratic institutions⁹.

While very realistic about the likelihood of Putin's return to the Russian presidency, the international investment community (whatever the views of the Russian voters) seemed to be energised by the prospect of a second Medvedev term. Few were under any illusions about Putin's role as the ultimate decision maker, but the analysis ran that a second Medvedev term would see a more confident Medvedev returned, with a more secure mandate to force the pace of change and to be more personally assertive in forcing economic modernisation and development of democratic institutions. Such was not

⁸ See also Surkov's remarks quoted in note [18] below.

⁹ The move of Vladislav Surkov to deputy prime minister with special responsibility for modernisation and innovation – a role he has had behind the scenes as deputy chairman of the President's modernisation commission – could be a tacit acknowledgement of this by the Kremlin itself.

an implausible outcome. Puppet or not, as president Medvedev has displayed personal stature, created a new public face for the administration and championed an agenda that is different and much more progressive than what went before. At the same time, some thought Putin might have become less interested in government per se and that he might be content with the power to veto, oversee and, out of whatever concern, manage the succession. It was believable therefore that the status quo would suit them both and that what had been portrayed as a wrong-way-round arrangement with Putin as the “Number Two”, has with the passage of time, come to seem right with a head of state vastly more contemporary in his outlook and manner than his patron.

Whether or not these views were shared by the majority of domestic opinion is a question that it is always difficult to answer. Russians did not believe that Medvedev was an independent agent and could find little reform to show for his big words. But the general sense of disappointment at the announcement of Putin’s return for a third term was nevertheless palpable. It seemed as if a second Medvedev term was indeed, out of the limited options, the more acceptable outcome if only for the fact that it would have shown some deference to whatever scant mechanism exists for protecting the Russian state from monocracy. Putin’s decision to allow Medvedev just a single term, before seemingly pushing him aside, seemed to show contempt for a constitution that originally set out to avoid Russia reverting to a series of presidents for life – Soviet style. Even the manner of the announcement seemed to irk observers whereby, at the United Russia Congress on 24 September 2011, the President proposed that the Prime Minister should stand for the presidency in 2012 and the Prime Minister accepted and then immediately offered Medvedev to stand on the United Russia ticket in the parliamentary elections in December¹⁰ and to become Prime Minister at the end of his presidential term.

Winter of Discontent

The first sign that public tolerance of “Putinism”, if not Putin himself, might be cracking came on 20 November 2011, when Putin attended the mixed martial arts fight between Fyodor Emelyanenko and Jeff Monson. As he stood in the ring at the end of the fight to congratulate the pugilists, he was, for the first time anyone can remember, publicly jeered. It was a notable crack in the thin veneer of public stoicism that received widespread comment in the independent press and judicious editing on state TV. The speculation about why the crowd had booed was much less interesting than the simple fact that they had.

Matters moved quickly from that point. The Duma elections that were held on December 4th were widely regarded as fraudulent with allegations of the ruling United Russia party committing abuse of administrative resources to bolster its vote as well as ballot stuffing at the polling stations. Indeed, the written media had remarked on how virtually identical posters appeared across Moscow both to promote the election and to promote United Russia which seemed to be a careless use of administrative resources. However,

¹⁰ Although strictly it was not necessary for Medvedev to be an elected member of the parliament.



On 20 November 2011, Putin was booed for the first time anyone could remember. The speculation about why the crowd had booed was much less interesting than the simple fact that they had. (PHOTO: Agency photo ITAR-TASS)

even with all of that, the elections resulted in United Russia polling just 49.32% of the votes as against 64.3% in 2007. This translates to a loss of 77 seats in the Parliament and effectively a loss of 14.98% of the total votes in parliament. This does not mean that Putin now lacks a functioning majority, but does throw quite a spotlight on the ruling party's declining popularity

The election result may not have been a complete surprise to Putin who had already launched his plan to broaden out United Russia's constituency, the foundation in some regard of his own legitimacy, beyond an increasingly narrow (as it was proved by the December election result) group of die-hards, Nashi groupies and the like, into a *"broad popular front [of] like-minded political forces"*, as Putin himself described the "All Russia People's Front" when he launched it at a meeting of United Russia on May 6, 2011. The popular front would, he said, include members of United Russia and other political parties, business associations, trade unions, and youth, women's and veterans' organisations in order to provide United Russia with *"new ideas, new suggestions and a new face"*. Putin's idea was that non-party candidates nominated by these various organisations would be included in United Russia's party list to participate in the Duma elections; but, whatever the merits of this might be in the long run, it clearly did not happen soon enough for the elections in 2011.

As is well known, the presidential announcement and the subsequent controversy over the Duma elections sparked the largest mass protests in Moscow since the fall of the



Troop carriers (all fully manned) are lined up in front of the Bolshoi Theatre in case of trouble on 10th December 2011 but the protests have been peaceful.

Soviet Union with some 50,000 gathering at Bolotnaya Square – across the river from the Kremlin (although not in view of it). Buoyed by such support, the organisers immediately announced a second such protest that took place on December 24th on Prospekt Sakharova with an estimated 80,000 turning out. Protest meetings also occurred in many other Russian cities so that the movement is not just confined to Moscow.

The underlying cause of the protests is a matter for speculation at this time. In all likelihood it was the usual “powder keg waiting for a spark” that is well known to history. Putin remains very popular with less well-off sections of society toward whom he is indulgent, fighting for higher pensions, better living accommodation and doling out generous disaster relief such as after the forest fires in 2010. But Russian society is visibly changing and becoming more sophisticated and “middle class” (regardless of income) leading to different and higher expectations of national government than mere “stability” and hand-outs. Small signs give this sociological change away; such as the number of Russian Volga and Lada car models in Moscow being a fraction of the number of five years ago, and the westernisation of fashion styles and widespread coffee bar culture. While crediting Putin with the suppression of the criminality that prevailed in Russian society in the 1990s, all ranks, but especially the educated and professional classes, are increasingly intolerant when they suspect criminality among the political classes. They want economic policy and budget allocation to be based on sound principles without the involvement of vested interests. What is more, educated voters understand the pre-

carious nature of the Russian economy – the kind of risks which are discussed in the first section of this review – and want to know how those threats to their collective future will be addressed. Neither Putin's presidential nor United Russia's election campaigns, gave any acknowledgement to these problems or set out any strategy for dealing with them. Putin justifies his leadership by always looking backwards, and what seems to be different this time around is a view that re-assuming the presidency, without providing any forward-looking manifesto, is not acceptable.

Whatever the true causes of the current protests are, their key significance is that unlike the violent demonstrations that took place at the same time in 2010 which at first looked like mass demonstrations against state, but were actually race riots, the demonstrations of December 2011 are clearly political, middle class and very angry – although entirely peaceful¹¹. The presence at the meetings on Prospekt Sakharova of the former finance minister Kudrin as well as society "It" girl Ksenia Sobchak, a family friend of Vladimir Putin's, lends further weight to the movement. Most significantly, these protests, that are set to continue, are anti-Putin whereas the pattern of opposition activity in Russia, including those that we reported on in our 2011 Review, has been more human rights based. At that time we noted that these movements and regular, if small scale, protests could be the start of a developing movement for change, particularly among the middle classes, that eventually would become significant. At the end of 2011, it looks as if that process might be gaining some real momentum and that it is likely to be significant factor in Russian politics in 2012 as Putin finds that his credits from the first two terms are used up and the Russian urban middle class at least, starts to be more outspoken against him. Indeed, as events developed in the last weeks of 2011, the very durability of the regime was being called into question by some commentators and this is a new (although in our view unlikely) political possibility that has not been so much as uttered in mainstream opinion since Putin emerged as Russian leader and ended the Chechen War.

End for Putin?

We do not think this is the end for Putin. In the absence of a well-functioning democracy, it is difficult to say whether a majority of Russian voters is delighted with the Putin/Medvedev tandem (it is clear that at least a vocal section is not) or would prefer one more than the other; whether they calculate pragmatically that, in the absence of plausible alternative candidates they probably would not seek a different outcome to Putin in free and fair elections (probably) or whether they are merely apathetic (we do not think so). It is often said, as much by Russians of themselves as by others, that the Russians have always lived under forms of dictatorship and Russia can only be ruled that way. Most likely all views are represented, but a general consensus that Vladimir Putin was the saviour of Russia from the Yeltsin chaos and is still the best chance for political and social stability in the absence of a working democratic system, remains the most

¹¹ Friends of the writer who attended the meeting at Bolotnaya found there face painting and other activities laid on for the children.



Communist party rally in central Moscow on 18 December 2011: colourful, but hardly a fighting force.

significant prevailing force in Russian politics. From this point of view, notwithstanding disillusionment, disappointment and the strengthening protest movement, the Putin administration and therefore Russian politics is probably stable for at least some years yet – assuming he keeps his health¹² and does not tighten the screws too much.

It is certainly doubtful that Putin should completely recover his “popular politician” epithet after the events of November and December 2011, but in the absence of an alternative, love him or hate him, the continuance of the Putin regime through and beyond 2012 is not really in doubt. It does certainly seem that a sizeable majority voted against United Russia in the Duma elections, but it is much less clear that they meaningfully voted for any of the alternative candidates and, indeed, protest votes are an affordable luxury in Russia where opposition parties stand no chance of power whatsoever. For the time being, without an alternative credible government party or plausible presidential candidate and with memories of the 1990s still raw, a “Russian Spring” in 2012 seems most unlikely.

The progress or otherwise of opposition groups and whether they can unite to any extent to form an effective opposition in the medium term, or frankly do anything to unseat Vladimir Putin, will be a topic to watch during 2012 and particularly during the presidential election process when opposition politics will, uncommonly, have centre

¹² This is another question of course. The ‘Kremlin’ consists of a ruling elite and not just Vladimir Putin and there are a number of strong individuals – some more liberal than he, some less. It must be assumed there is a nominated successor but there can be no certainty that an untimely change would be without a struggle. However, the power structure in Russia does not seem to be such that it would necessarily topple without Putin – for the same reasons that he faces little opposition to his continuing rule at this time.

stage at least for a while. There are indeed opposition spokesmen, including the leaders of the minority parties in the Duma, but they are not a realistic challenge to Putin. Even though the left wing Communist Party, led for years by Gennady Zyuganov, polls around 20%, that's about its limit and in reality it has no substantive electoral significance or very obvious desire to form a government. Vladimir Zhirinovskiy's right wing LDPR and Fair Russia, led by Sergey Mironov, each poll above 10%; but, in reality, all these parties have small constituencies and are unlikely to make much further headway¹³.

Outside the mainstream, Boris Nemtsov has been a constant presence at the head of various opposition groups such as Strategy 31 and "Solidarnost" (which was a prime mover in the December rallies), but suffers from previous failed attempts, which, as regards the "memories of the '90s" factor in Russian politics, may be a little too close to that era to mount any real challenge. In February 2011, a well-known campaigner, Alexey Navalny, gained widespread popularity after he called United Russia the "party of crooks and thieves" in a radio interview and the jibe has stuck. Navalny has been running a concerted whistleblowing campaign against the state run corporations, garnering a considerable following on the internet. Navalny has been quite vocal during the recent protests, including seeming to incite a move on the parliament building, and was for a time spoken of as a presidential contender. Unofficial polls had already shown him to have a considerable constituency¹⁴ although some of his own political views are likely to be a little too right-wing for many of the "Decembrists" of 2011. In any case, Navalny is too late to register his candidacy so that from this point of view any threat he poses to Putin's presidency is for another day.

The declared candidates for the March presidential election are less obviously populist. They include Russian billionaire business tycoon and shareholder/director of Norilsk Nickel, Mikhail Prokhorov who first weighed into the political frame in summer 2011 in a short-lived episode discussed below. He declared his intention to run for president in 2012, but his unclear relationship to the Kremlin and his overtly pro-business manifesto for longer working hours and easier dismissal of workers would make him an unlikely beneficiary of the popular mood. Besides him and Putin, Gennady Zyuganov (*Communist*), Sergey Mironov (*a Fair Russia*) and Grigory Yavlinsky (*Yabloko*) are either already registered or declared candidates. However, according to polls, the gulf between Putin and any of the other candidates is in the order of 30% or even more.

The serious point from all this discussion of opposition candidates is that there are no political parties and very few, if any, individuals in Russia who have both the necessary platform and the public's trust to provide leadership and voice to any movement for political change or to bring together the soup of disjointed opposition groups as a serious counterbalance to the present administration. No one believes this more than the Prime

¹³ Communists: 19.2% , LDPR: 12%, Fair Russia: 13.25% in the (controversial) December 4th elections.

¹⁴ As reported by the Guardian (23 February 2011) in a poll conducted in October 2010 by Kommersant, Russia's leading newspaper, it was found that if elections were held for the mayoralty of Moscow, Navalny would win an undisputed victory, with 45%. Opposition politician Boris Nemtsov and the current mayor, Sergei Sobyanin, lagged far behind with 12% and 2.8% of the 50,000 polled.



Anti-Putin protests in December: Their message was not well articulated, but the emotions ran high. What they were probably demanding was Putin with a functioning Duma and not for Russia without Putin. (PHOTO: RIA Novosti)

Minister whose strategy in response to the recent protests has been to mock them as a rag-tag protest movement with no leaders and no legitimacy to negotiate with the “elected” leaders of the state. Although Putin’s contempt for the protestors is extraordinary, his analysis is technically correct. Russia remains a country with an increasingly vocal and unhappy professional middle class, but without any mainstream opposition and without any executive accountability and it is unlikely that mainstream opposition will emerge for as long as opposition can only be voiced on the streets, outside the political system and with no constitutional obligation on the executive to engage with it.

No doubt this is why the widespread suspicion of Duma election rigging has caused such fury: without a basis for fair elections and the creation of an effective political dialogue within a functioning parliamentary system, an opposition party with a popular mandate and a decent shot at government cannot gain a platform and the executive will continue to be controlled by “insiders” – as it has been since Lenin. What the voters seem to have voted for, in truth, and maybe what the protestors were protesting for¹⁵, is for Putin with a functioning Duma and not for Russia without Putin.

¹⁵ Anecdotaly, it is not at all clear that the dissenting voters and the protestors are one and the same.

The Future for Russian Democracy

As we observed in our review of 2010, while remaining fundamentally statist and advocating the merits of political management over popular democracy, both Medvedev and Putin in various statements over the past years have suggested that their long-term agenda is to use the executive mandate to create some viable political and democratic process, if only to deal with the inevitability of succession and the problem of legitimacy as the high offices of state cannot forever be simply passed back and forth between them. Medvedev, characteristically, has been much more outspoken referring more specifically to viable opposition and making the system “less stale”, whereas Putin, as one would expect, has been far more reticent on the topic. Leaving aside Putin’s contempt for the protestors, his most recent musings on the matter of democratic change in Russia that might be regarded as reflecting his considered view, were made at the Valdai Club meeting in November 2011 (pre-riots) where he expounded the merits of the current “managed democracy” (or some say autocratic) system in achieving stability and growth, but conceded that there has to be some change:

“It doesn’t mean that political system needs to be frozen. Our Constitution was amended and you know it. We do not believe that this is where the development of our political system has to stop. We are thinking of ways to bring our federal, regional and municipal authorities closer to the people, so that the people could have a bigger influence on the power and could expect to get some feedback. Of course, our political system is not perfect. We realise that and we are also aware of the criticism that has been levelled against the power configuration that we proposed earlier with President Medvedev. But here’s a point I would like to make, I am not aware of any perfect governance systems.”¹⁶

In contrast to Medvedev’s musings on the same topic, Putin is far more conservative – ways to bring the federal structure closer to the people and for the people to “have a bigger influence on the power and...get some feedback” hardly promises a political revolution (though it would be an improvement) and his belief that there is *no perfect governance system* clearly signals that his own political philosophy is non-aspirational in this respect. It will be disappointing indeed if such reforms as he has in mind amount only to the direct election of regional governors and simplification of the registration process – concessions that were announced in late December 2011 and so were likely to have been in hand already – and this may not be enough to quell the protestors and keep a lid on the pressure now mounting against the political structure from the growing Russian middle class. On that basis, we think there is probably more to come unless the improvement of the candidate registration process really does allow the kind of independent candidates into the parliament that can successfully invigorate the parliamentary process.

The extraordinary pantomime in the summer of 2011 involving Mikhail Prokhorov may have been part of the process of managing democratic change, but, if so, it was rather

¹⁶ Text taken from Valdai Discussion Club website.

a damp squib. In the early summer of 2011, Prokhorov suddenly entered the political fray, overnight becoming installed as leader of the right-wing Right Cause Party and announcing that he was a presidential hopeful. Posters were stuck to billboards throughout Moscow and the countryside as part of a massive publicity campaign promoting him as an independent outsider standing on a pro-business ticket. But the campaign was short-lived and on 15th September 2011 the Right Cause delegates voted Prokhorov out.

Although strongly denied by the man himself, Prokhorov was widely seen as a Kremlin-backed stooge and could not escape speculation that his sudden emergence at the leadership of Right Cause had been orchestrated by the administration as part of a plan to window-dress Russian politics, create the semblance of opposition and make it seem less like a one-party system although, in truth, the Duma seats held by Right Cause represent decimal places in terms of overall seat numbers. Such a view would not have distressed the Kremlin as it has always been clear that United Russia and to some extent Just Russia were parties that were created as part of a Kremlin project to manage the development of democracy in Russia. That the Prokhorov affair may also have been part of the same management of the political system, has gained some credence following the remarks of the ex-finance minister Alexei Kudrin, quoted in *Vedemosti* in December 2011, where he said that Dmitry Medvedev had repeatedly asked him to head the Right Cause Party: *"I said no...as I realised that Right Cause, with its unclear people and significant control from the Kremlin, would be absolutely powerless"*. If the Prokhorov affair was such an attempt to play at king-making, the Kremlin might have to try something different next time.

What they might try is a little more subtlety. In a very intriguing development coming as it did so hard on the heels of the highly controversial election process, Vladislav Surkov was moved on 27 December 2011, from his post as First Chief of Staff of the Presidential Administration to the largely ceremonial role of Deputy Prime Minister where there will be little or no call for his Machiavellian skills or vent for his ideologies¹⁷. Surkov has been one of the most powerful men in Russia and the Kremlin's chief ideologist since Putin came to power in December 1999. He is widely thought to be the architect of Russia's centralised and managed political system as well as its chief "maintenance engineer". He is at any rate a leading exponent of it. Throughout the last ten years it has been Surkov who has principally managed the Putin/Medvedev administration's public sphere (i.e. "election campaign") and he has done so enthusiastically by intervening in legislation on political parties, managing the electoral process and close monitoring of the media. Prokhorov accused him of being behind his deposition as party leader of Right Cause. The practical effect of these measures has been stifling of media debate (though more so in television than in the written media), the virtual elimination of independent candidates in elections and the eradication of the political pluralism that emerged, albeit chaotically, in the 1990s. Some commentary on these issues paints a

¹⁷ For British readers, it's a bit like Alastair Campbell, whose role as Director of Communications and Strategy under Prime Minister Blair was broadly similar to Surkov's as first chief of staff and who, at least in terms of reputation, is a man having something in common with Surkov, becoming Minister for, say, Health or something equally prosaic.



Billionaire businessman and owner of the American basketball team, the New Jersey Nets, Mikhail Prokhorov, entered Russian politics in June 2011. (PHOTO: Agency photo ITAR-TASS)

very dark picture indeed of the modern Russian state and Surkov is often regarded as the dark force behind it, by the Kremlin's critics¹⁸.

Be that as it may, Surkov's move to other duties at a time of significant political protests is significant although he himself announced that he was satisfied with the move and that he had requested "a new life" as a New Year gift from the President¹⁹. However, both the United Russia party and its youth wing "Nashi" are largely his creation and it is most probable that his star has fallen with the fortunes of the party and its poor showing in the December elections and that Putin now feels a real and urgent need to reinvigorate his electoral appeal by other means²⁰.

Surkov's place is taken by Vyacheslav Volodin, a long-time party apparatchik within United Russia. More recently and possibly significantly, Volodin has been a key player in Putin's "All Russia People's Front" which may be a sign that Putin now intends to

¹⁸ Interestingly, Surkov himself portrays this period and his part in it, as more of an evolution: "I was among those that helped President Yeltsin to conduct a peaceful transition of power; among those that helped President Putin stabilise the political system; among those that helped President Medvedev to liberalise [the political system]..." statement to Interfax quoted in Lenta.ru following the announcement on 27 December 2011.

¹⁹ "Я довольно давно просил руководство дать мне возможность начать с Нового года новую жизнь. Был понят, за что большое спасибо": as quoted by Interfax.

²⁰ There is an interesting profile of Surkov by Richard Sakwa, Professor of Russian and European politics at the University of Kent, England, as well as profiles and comment on other Russian politicians, which can be read at www.opendemocracy.net. We have not considered the political affiliations of this site, as the tendency to describe Surkov as a "dark prince" is fairly widespread and it is what he signifies in the popular imagination rather than his personal ethics that is relevant to this discussion.

give serious backing to the concept of *“new ideas, new suggestions and a new face”* and will seek to embrace a broader constituency through dialogue. What remains to be seen, however, is the extent to which that constituency will embrace the “middle classes” that have turned out in such number to oppose him. It is not obvious from the initial list he gave of *“members of United Russia and other political parties, business associations, trade unions, and youth, women’s and veterans’ organisations”*, that it does embrace those middle classes, but let’s see.

Russia on Trial

Berezovsky v Abramovich

A reminder of the 90s factor that seems to keep Vladimir Putin almost permanently in power, was presented in 2011 by the legal face-off between Boris Berezovsky and Roman Abramovich that commenced in the London High Court in October – another case of Russia airing its dirty laundry in public.

The case involves a controlling stake in the oil and gas company Sibneft that was sold by Abramovich to the Russian gas giant Gazprom in 2005 for more than USD 13 billion. Berezovsky was formerly a close advisor to Boris Yeltsin and became an outspoken critic of Vladimir Putin for which he became persona non grata with the new administration causing him to flee to Great Britain in 2001 and become something of a political hot potato with regard to the UK’s relations with Russia ever since. Berezovsky’s case alleges that after his fall out with the new presidential administration in Russia, Abramovich, with whom he alleges he was at that time “very good friends” and “a father figure”, “betrayed and blackmailed” him into selling a valuable stake in Sibneft at well below its value by threatening that if he refused, Abramovich would ensure that Putin intervened and the shares would be expropriated. According to Berezovsky’s testimony, this intimidation led to him disposing of his 21.5% stake in Sibneft. Berezovsky claims damages to the tune of USD 5.6 billion.

Abramovich’s account in turn presents a different story. His submissions state that Berezovsky was never a close friend and allege that he extorted significant sums of money from Abramovich for providing “protection” services. Abramovich described himself as a “milking cow” providing the funds (around USD 80 million annually and up to a total of USD 2.5 billion over the course of six years) for Berezovsky’s billionaire lifestyle. He claims that he finally paid a lump sum of USD 1.3 billion to the “godfather” in order to buy himself out of the “protection” deal.

As with any litigation, both accounts are plausible. The case continues, but whatever the outcome (and we offer no view on the merits of the parties’ respective positions), the pleadings on each side describe a lawless, oligarch-dominated Russia in the 1990s that voters in Russia fundamentally want to forget and this is why they stick with Putin who, it is widely assumed, put a stop to that as well as to much of the criminality of that time.

Yukos

2011 also saw the publication of the European Court of Human Rights judgment in the Yukos case²¹ – the most widely reported example of what Berezovsky alleges he feared from the new Presidential administration in Russia. Whereas in our Review of 2010 we anticipated that the judgment would go against the Government, the ECHR judgment turned out to be extremely finely tuned and both parties felt they had “won” in a way that showed their very different perspectives. As we expected, the Court found that the company’s rights had been violated in relation to the manner in which the proceedings had been conducted against it by the Russian state. Of particular relevance for the company were the findings and comments in relation to the claims that the Russian Government had denied the company a proper chance to prepare its defence²² and in relation to the seizure order of 14 July 2004, which set in motion the process of auctioning OAO Yuganskneftegaz²³ and the imposition of an additional 7% enforcement fee for immediate payment in relation to which the Court concluded that “on the whole, given the pace of the enforcement proceedings, the obligation to pay the full enforcement fee and the authorities’ failure to take proper account of the consequences of their actions, ... the domestic authorities failed to strike a fair balance between the legitimate aims sought and the measures employed.”²⁴

But motive is always more difficult to prove and on the most politically sensitive claim, that the Russian Government had misused the legal procedure in order to dismantle Yukos²⁵, the claimants did not succeed. This was the “key conclusion” and surely a major relief for the Russian Government. As member of the house committee on legislation, Dmitry Vyatkin dutifully told Itar-Tass: *“The Strasbourg court confirmed the absolutely obvious fact: there was no politics in the Yukos Case. Criminal prosecution was purely economic, with the view of recovering unpaid taxes to the budget. This money was eventually used for payments under social programmes. The Yukos case sobered up those in Russia who engaged in tax evasion using various schemes”*²⁶.

The company, in contrast, saw it thus:

“YUKOS OIL COMPANY WINS MAJOR RULING FROM THE EUROPEAN COURT OF HUMAN RIGHTS

²¹ OAO Neftyanaya Kompaniya Yukos v. Russia.

²² “...the mere four days during which the applicant company could have access to the case materials were insufficient for the applicant company to prepare properly, no matter the number of lawyers in its defence team or the amount of other resources which the applicant company would have been able to commit during its preparations.”

²³ “Although the Court, in principle, does not find the choice of OAO Yuganskneftegaz entirely unreasonable, especially in view of the overall amount of the tax-related debt and the pending as well as probable claims against the company, it is of the view that before definitively selecting for sale the asset that was the company’s only hope of survival, the authorities should have given very serious consideration to other options, especially those that could mitigate the damage to the applicant company’s structure. This was particularly so since all of the company’s domestic assets had been attached by previous court orders (see paragraph 27), and were readily available, the company itself did not seem to have objected to their sale (see paragraph 159) and there had been virtually no risk of the company seriously opposing these actions.”

²⁴ Paragraph 657. The relevant parts of the decision are paragraphs 657 – 658.

²⁵ The claim was formulated under article 18 of the Convention “The restrictions permitted under [the] Convention to the said rights and freedoms shall not be applied for any purpose other than those for which they have been prescribed.”

²⁶ September 20 (Itar-Tass).

Strasbourg 20 September 2011: The European Court of Human Rights today ruled in favor of YUKOS Oil Company in its complaints against the Russian Federation. The court held that the company did not receive a fair trial and that the enforcement of the tax liabilities against YUKOS Oil Company, their speed and the selection of Yuganskneftegaz for sale for initial payment of taxes were inflexible and dealt a "fatal blow" to the company, and so were disproportionate. The judgment vindicated YUKOS' rights as an applicant, although the company had been dissolved under Russian law in 2007."²⁷

It is impossible to read the pedantic judgment in the case without a constant anticipation of what will be the Court's finding on its most salacious aspect – the "political motivation" point. From this point of view, the judgment was a bit of a let-down for Russia's detractors as the Court indeed stated that it found no evidence that the State had misused the proceedings with a view to destroying the company and taking control of its assets. Although the company did not succeed in getting the Court to make a connection between its findings on the manner of enforcement and the question of motivation, the circumstantial evidence got a pretty good airing nevertheless and the actual text of the of the judgment at this point, having emphasised the legal coordinates by stating that *"in order to hold a member State liable under [article 18 if the Convention] an applicant should be able to furnish the Court with an incontrovertible and direct proof in support of his or her allegations"*, concluded:

"...the Court finds that it is true that the case attracted massive public attention and that comments of different sorts were made by various bodies and individuals in this connection. The fact remains, however, that those statements were made within their respective context and that as such they are of little evidentiary value for the purposes of Article 18 of the Convention. Apart from the findings already made earlier, the Court finds no indication of any further issues or defects in the proceedings against the applicant company which would enable it conclude that there has been a breach of Article 18 of the Convention on account of the applicant company's claim that the State had misused those proceedings with a view to destroying the company and taking control of its assets."

This is not quite the same as confirming as "an absolutely obvious fact" that "there was no politics in the Yukos Case", but clearly the Russian Government will be relieved if such cannot be legally proven. As well as this, if the speculation against the Government got a good airing, so too did the Government's position on the basic tax case. In this regard, the Court concluded that the findings of the domestic courts – that applicant company's tax arrangements were unlawful at the time when the company had used them – "were neither arbitrary nor manifestly unreasonable" and that the "relevant case files contained abundant witness statements and documentary evidence

²⁷ This is taken from the "Yukos Library" website, which is assumed to represent the company's position although its actual credentials are not stated anywhere. Indeed, the credentials of any party speaking on behalf of the underlying claimant/s is a matter of much uncertainty, extending to the rights of Mr Piers Gardner to appear as counsel for the claimant in the proceedings – see dissenting judgment of Judge Bushev at paragraph 4.1.

to support the connections between the applicant company and its trading companies and to prove the sham nature of the latter entities. The applicant company itself did not give any plausible alternative interpretation of this rather unambiguous evidence, as examined and accepted by the domestic courts.” As such, the outcome of this case will have done little to boost public sympathy for Yukos and its promoters, including Mikhail Khodorkovsky, at least in Russia, and the Government will not be discontented.

Besides showing up Russia’s belief that persons can, by their bad faith actions, place themselves outside the framework of human rights, for foreign investors the case can now be seen to be one on its own very particular (and extreme) facts and, as such, to have little real relevance (unless they plan to engage in wholesale tax evasion). One thing that the ECHR’s detailed and very balanced analysis of the Yukos story may achieve is to put this one to bed so far as commentary on Russia as a foreign investment destination is concerned and that will be a good thing.

Conclusion

It is extremely difficult to write an opinion piece on the state of Russian politics as mass protests erupt on the streets of Moscow in the last days of 2011. There seems to be a force for change at large in the country (or at least in Moscow) and the Putin/Medvedev tandem seems a bit more vulnerable than it did just a month ago. It is hard, however, to envisage anything other than a Putin presidency in March 2012. The ruling elite have not yet lost control of the state and the extent of that control, if they want to use it, is vast. Increasing public disorder is no surprise and indeed two years ago we thought there might have been more of it as a result of the crisis. Neither does the recent emergence of a more vocal opposition to Putin mean of course that the same people had previously loved him. The fact is that popular appeal is irrelevant to Russian politics, which is still about being able to create and maintain stability. It is not necessary to love Putin to understand his importance to Russia’s stability, and the consensus on stability is where the bulk of the electorate has common cause with the leadership. The spectre of the chaotic Yeltsin era and its legacy remains very real; and, frankly, no one knows what factions exist among the ruling elite, so Putin’s demonstrated ability to ensure stable government and keep whatever factions at bay, is going to remain a sure vote-winner in Russia. For the time being at least, it will be hard for any Kremlin outsider to persuade voters (including those middle class urban voters who voted Yabloko, Communist or whatever in the Duma poll just to make a point) that they could hold it together as well.

However, the Kremlin is indeed under real pressure to change and improve the country’s record on corruption and non-transparency and even to improve its democratic institutions. The pressure to pursue such an agenda is from all sides, including external forces that were not a present reality in Putin’s previous term, such as accession to the WTO and the financial crisis from which Russia is by no means immune as a slowing of foreign investment reduces Russia’s ability to improve its finances in the short term and



Putin's publicity shots to date portray him as the common man reaching out to the common man, among whom lies his principal constituency. However, his carefully constructed personal image may need a make-over, as United Russia's bad showing in the December elections exposes a need for Putin to appeal to a more critical, urban, middle class and unconvinced electorate. (PHOTO: Agency photo ITAR-TASS)

jeopardises its vital longer term economic growth. And no world leader has the resources anymore to avoid domestic realities by indulging in big foreign policy distractions. In any case, any leader needs some legitimacy and Putin seems to have shown signs that he is aware of this in his promotion of the, at first quite strange, All-Russia People's Front as a way toward a new look and constituency for his principle power-base, United Russia.

It is not just pressure from external factors that might be a force for change. Perhaps more important is Putin's own psychology. Putin is highly competitive and will want to distinguish himself from the perceived failures of Dmitry Medvedev of which the most notable, according to the general view, is the failure to take effective action on the matter of corruption. What is more, for all his unruffled appearance, Vladimir Putin will not like the jeering. In his own way, Putin has always worked hard to be a popular politician investing heavily in his personal brand as a "real Russian man" and performing macho photo stunts that seem very curious to Western eyes, but which are carefully choreographed to improve his popularity with Russian voters. In this respect, being personally named and blamed for the serious delinquencies of the state and having his unpopularity, even if only among the urban professional class, exposed is a clear reverse for him. This, rather than his political future, which he clearly does not think is in any doubt, may be what is exercising Mr Putin – although to be frank, he seems not much bothered at

this time. He will surely be aiming for an outright and uncontroversial win in the first round in March and a better bonding with those sections of the voting public that have come out in force against him, namely its professional, urban middle class (whose perspective may be closer to the needs of business indeed) so that, for all his apparent contempt for the protesters, we could be seeing rather more investment in his forthcoming presidential campaign than might otherwise have been the case and the replacement of Surkov may provide a clue about this strategy to broaden his appeal.

After the election, behind no doubt the same rhetoric in his third term as we have heard before, and some fighting talk over the heads of the protestors, there may be an attempt to reform the electoral system and create a more functioning parliament – in a way that Medvedev failed to do. If so foreign businesses will find that a very satisfactory political agenda and, in common with most Russians, will be happy if anything more dramatic than that, which might destabilise matters, is for the time being, left for another day.

December, 2011

This publication has been prepared for the purpose of comment only, and does not constitute legal or professional advice. The information is based on secondary sources, has not been separately verified by CMS and relates to circumstances prevailing at the date of its original publication and may not reflect subsequent developments. For specific advice please contact us:

CMS, Russia

119019 Moscow, Russia
11, Gogolevsky boulevard
Tel. +7 495 786 4000
Fax +7 495 786 4001



Contact us:

CMS, Russia
11, Gogolevsky blvd.
119019, Moscow, Russia
Tel.: +7 495 786 4000
Fax: +7 495 786 4001

CMS in Russia is a representative office of CMS International B.V., a limited liability company registered in the Netherlands.

CMS aims to be recognised as the best European provider of legal and tax services. CMS operates in 30 jurisdictions, with 55 offices in Western and Central Europe and beyond. CMS was established in 1999 and today comprises ten CMS firms, employing over 2,800 lawyers. CMS is headquartered in Frankfurt, Germany.

CMS member firms are: CMS Adonnino Ascoli & Cavasola Scamoni (Italy); CMS Albiñana & Suárez de Lezo, S.L.P. (Spain); CMS Bureau Francis Lefebvre (France); CMS Cameron McKenna LLP (UK); CMS DeBacker (Belgium); CMS Derks Star Busmann (The Netherlands); CMS von Erlach Henrici Ltd (Switzerland); CMS Hasche Sigle (Germany); CMS Reich-Rohrwig Hainz Rechtsanwälte GmbH (Austria) and CMS Rui Pena & Arnaut (Portugal).

CMS offices and associated offices: Amsterdam, Berlin, Brussels, Lisbon, London, Madrid, Paris, Rome, Vienna, Zurich, Aberdeen, Algiers, Antwerp, Beijing, Belgrade, Bratislava, Bristol, Bucharest, Budapest, Buenos Aires, Casablanca, Cologne, Dresden, Duesseldorf, Edinburgh, Frankfurt, Hamburg, Kyiv, Leipzig, Ljubljana, Luxembourg, Lyon, Marbella, Milan, Montevideo, Moscow, Munich, Prague, Rio de Janeiro, Sarajevo, Seville, Shanghai, Sofia, Strasbourg, Stuttgart, Tirana, Utrecht, Warsaw and Zagreb.

www.cmslegal.ru
www.cmslegal.com