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The Return of Vlad

(NB: Due to a heavy schedule of presentations, the next report will be published October 17th.)

Last week, Vladimir Putin, the former president and current prime minister of Russia, decided to return to the presidency. The Russian Constitution precludes three consecutive presidential terms. So, in 2008, Putin stepped down from the presidency but engineered his succession. A member of his government, Dmitry Medvedev, was essentially appointed to replace him as president. Elections will be held in March 2012. Until last week, it was unclear if Medvedev would run for a second term (and if Putin would let him) or step down for Putin to return. That question has been answered. Interestingly enough, Putin endorsed Medvedev to be his prime minister.

These two decisions have surprisingly led to serious dissent within the Kremlin. Most markedly, Finance Minister Alexei Kudrin resigned on September 26th because he opposed Medvedev's appointment to prime minister. Media reports suggest that Kudrin had designs on the prime minister's job and was disappointed that he didn't get it. However, we believe that this reason is far too simple. Instead, we believe that Kudrin's decision was more tied to internal divisions within the Kremlin. These divisions define the Russian government; the genius of Vladimir Putin is his ability to manage these divisions, or clans.

In this report, we will describe the divisions within the Kremlin, the effect of these divisions on domestic and foreign policies and how Putin will manage these splits going forward. As always, we will conclude with potential market effects.

The Russian Power Structure

Although Russia is nominally democratic, in reality, it is an authoritarian state. Power resides with Vladimir Putin, regardless of his political position. The current power structure has evolved over the past decade with Putin playing the role of allocating influence. When Putin took power as president in 2000 (officially, December 31, 1999), he had several powerful entities to control. The major groups were the intelligence agencies, the "oligarchs" (CEOs of various companies), the market liberals and the "Yeltsin family." With precision, he neutralized those "clans" that didn't fit his vision of Russia. The Yeltsin family was emasculated, uncooperative oligarchs found themselves either in jail or in exile, and the market liberals were discredited by the collapse in the economy in the late 1990s. Putin, a former KGB agent, threw his lot in with the intelligence agencies.

There are two primary intelligence groups in Russia, the FSB (formerly known as the KGB) and the GRU, which is the military's intelligence apparatus.

The KGB and GRU were holdovers from the Soviet Union. Although the former is better known, the latter was larger and had a more global reach. During the Soviet era, these two intelligence agencies competed for influence, a situation that has persisted even after the fall of the Soviet Union.

Putin holds power by balancing the interests of the leaders of these two intelligence groups. The current leaders of these two clans are Igor Sechin and Vladislav Surkov. Sechin represents the FSB clan and Surkov the GRU clan.

Sechin's clan has been dubbed the "siloviki" which translates into "the strongmen." This clan yearns to return to the authoritarian Soviet days, minus the ideological baggage of communism. They want a highly centralized economy and long to return Russia to its former superpower status. Although we doubt they expect such status could be attained in the near term, regaining control of Russia's near abroad would be an excellent start.

In contrast, Surkov's clan is known as the "civiliki" or "the civilians." However, this is something of a misnomer. Surkov gets his power from the GRU's intelligence apparatus, who are very much "strongmen." The civiliki has a sub-clan which represents the economic liberals, technocrats with business skills. The early technocrats were a group of St. Petersburg lawyers and economists that grouped around Anatoly Sobchak, the mayor of St. Petersburg. This early group was discredited by the disastrous privatizations that occurred during the Yeltsin era. The privatizations, started by the economic liberals, were co-opted by the oligarchs, who were former government officials or Soviet state firm managers. The oligarchs enjoyed a financial windfall by

purchasing state assets at well below market values.

As Putin took control earlier in the decade, he viewed the civiliki, the economic liberals, as tied to the oligarchs. Thus, for the most part, he sidelined the civiliki as he moved against the oligarchs. Putin replaced the oligarchs with the siloviki; retired KGB agents were given control of important enterprises. Most of the siloviki took control of natural resource or defense companies, and laws were changed to seriously discourage foreign investment into these industries.

The commodities boom from 2002 to 2008 allowed the siloviki to expand their control. They aggressively borrowed from abroad to expand operations and buy out competitors. Often, these "mergers" would be on very unfavorable terms for the target company as the siloviki would use the levers of state power to force the sale. In many cases, these mergers made little business sense. Instead, they were done to expand political power.

Commodity prices peaked in July 2008. The subsequent decline put pressure on the Russian economy. When the financial crisis hit in the autumn of 2008, the siloviki were faced with collapsing commodity prices and a rapidly depreciating currency. The collapsing ruble was a particularly adverse circumstance because most of the foreign loans were denominated in foreign currencies. The siloviki were forced to petition the state for aid; the Medvedev administration was forced to bail out the siloviki at great cost.

Politically, the financial crisis discredited the siloviki and allowed the civiliki's standing to improve.



This chart shows Russia’s foreign reserves with ruble exchange rate. During the commodities boom, reserves rose strongly and the ruble appreciated. The global financial crisis led to a sharp drop in the ruble and a plunge in foreign reserves. These reserves were used to bail out siloviki who faced default on foreign loans. Since the crisis ended, the ruble has recovered and foreign reserves have risen.

Even though the civiliki had become discredited in the 1990s, Surkov recognized their talents and offered some of the leading figures protection. Over time, civiliki have adjusted to the more nationalist tone of Russia, becoming less free-market ideologues and instead adopting a purely technocratic mindset. Unlike the siloviki, the civiliki want to develop an economic system open to foreign investment, less dependent on natural resources with a robust private sector. The civiliki have mostly abandoned the desire for power and political intrigue. Instead, they want to build a Russian economy that is more “normal.”

Putin and the Clans

To understand how Putin manages the clans, it is necessary to capture the divergent trends within Russian history. First, Russia is a vast nation that covers nine time zones with widely divergent ethnic groups within its borders. Such geopolitical conditions are

not favorable to democracy but a breakup into numerous nations. To hold Russia together, usually a strong leader emerges who quells local unrest and stabilizes the nation. This is exactly what Putin has done, especially in the early part of his presidency. He consolidated power within the Kremlin, brought a brutal end to the unrest in Chechnya, ended the election of governors and appointed them from Moscow, and either co-opted or arrested the oligarchs.

The second problem Russia faces is that the process of maintaining control tends to undermine the economy. Authoritarian regimes, which tend to be ruled on the whims of the leader, are antithetical to capitalism, because the latter really needs the rule of law to flourish. Who invests when the legal safety of that investment is questionable? This is why Russia has traditionally based its economy on extractive industries, taking advantage of their natural resources.

Throughout history, however, once strong rulers gain control, they often try to boost economic growth by liberalizing parts of the economy. Unfortunately, the Russian population, living under the constraints of authoritarian governments, tends to be poor candidates for entrepreneurial capitalism. To address this problem, Russian leaders have invited foreign investors and immigrants to “teach” the Russians how to operate in a capitalist economy. Peter the Great invited Prussians to invest and move to Russia to boost growth. Catherine the Great did the same with the French.

Essentially, the Kremlin clans represent these two divergent trends. The siloviki represent the first trend; their focus is national security. The civiliki tend to represent the second trend; their focus is liberalizing the economy and lifting growth.

Russian history makes it clear that the second trend cannot occur without the first being accomplished. In other words, until the nation is secure, trying to liberalize the economy is impossible because the natural tendency of capitalism, freedom and self-determination, would tend to weaken the central government's grip on the country.

Over the past two years, Medvedev's policy has been to liberalize the economy. The engineer of that policy was Alexei Kudrin, the finance minister who recently resigned. Kudrin is respected by Putin because of his finance skills; more importantly, although a member of the civiliki, like Putin, he also was a member of the security services. Kudrin created a liberalization plan that was both aggressive and cautious. It was ambitious insofar as it wrested control of major companies from the siloviki, replacing them with trained civiliki technocrats. From inside the Kremlin, this part of the program was forceful. On the other hand, the program was cautious in its liberalization. The doors to foreign investment have not been thrown open widely and although technocrats are running companies, they remain mostly state controlled.

Medvedev's sub-clan within the civiliki has been pushing for more openness, including privatization and increased foreign involvement in the economy. This group has been disappointed with the Kudrin plan. In the Russian political system, the finance minister answers to the prime minister, not the president. Thus, until the aforementioned announcement, Kudrin couldn't care less that Medvedev didn't approve of his program. All that mattered was that Putin did. However, once Putin and Medvedev trade places, Kudrin would have been beholden to Medvedev who would have likely forced him to implement

a liberalization program he was uncomfortable with.

Putin was happy with Kudrin's program because it moved in a direction to modernize the economy without threatening national security. One would have to believe that he was uncomfortable with this resignation. However, he allowed it to occur, perhaps to offer the illusion that Medvedev has an independent power base. But, I would not be shocked to see Kudrin return to the Kremlin at some point simply because he is a man that Putin trusts.

Potential Policy Changes

On its face, Kudrin's resignation should lead to a more liberal economic plan going forward. However, we have serious doubt that Medvedev's sub-clan will rule the day. As noted above, Putin was comfortable with Kudrin's program. Thus, we expect that it will not be changed as much as Medvedev's group expects.

The siloviki will not be happy that Medvedev was given the prime minister's role. They view Medvedev as too accommodating to the West. In fact, the Kudrin sub-clan does too. Medvedev may need to bolster his foreign policy status by taking a hard line on some issue. At the same time, the West seems to be disappointed that they will be dealing with Putin again. Many Western leaders have taken a liking to Medvedev; for example, Putin opposed the Libyan no-fly zone but Medvedev championed it. Although some have suggested Medvedev has his own powerbase, we suspect that Putin didn't oppose the Libyan operation but knew the siloviki would. Thus, Medvedev gave him political cover for what he wanted all along.

Ramifications

Although some analysts are expecting the reversal of roles by Putin and Medvedev to make a major difference, we doubt that will be the case. We believe that Putin has been in power all along, and had it not been for that pesky constitution would have never left power.

What may change, however, is how Putin manages the two major clans. Clearly, the more national security oriented civiliki have lost power, and others within the Kremlin may depart or be forced out. However, we believe the civiliki represented by Kudrin may be overreacting to Medvedev's appointment. If so, we would expect them to slowly return to the Kremlin.

Overall, we would look for Russia to take a harder line in foreign policy but this is more a situation of form rather than substance. We doubt that Medvedev would approve of U.S./Israeli airstrikes on Iran, which would be no different than Putin's view. We still expect Russia to maintain friendly terms with Venezuela to the chagrin of the U.S., a

policy which began under Medvedev. In other words, we think the foreign policy divisions between Putin and Medvedev are non-existent.

In terms of openness to foreign investment, we believe this is a function of the global economy. If a recession brings a sharp drop in oil prices and Putin begins to worry about stability, we would look for a retreat on economic liberalization. In other words, it isn't just who is in power that matters; it's also a function of the long term policy trends within Russia.

What bears watching is how Putin manages the clans. It would appear that regardless of how this works, Medvedev will be Putin's sidekick. Their relationship appears to be useful to Putin. The real "theater" comes from the conflicts inside the Kremlin, but for foreigners, not too much will change.

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