RUSSIA

FINANCIAL TIMES **SPECIAL REPORT** | Thursday June 21 2012

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On the march: tax paying, private sector, internet savvy workers account for a growing percentage of Russia's population and it is chiefly from this group that the protest movement is drawn Getty

Country begins to tire of Putin's reign

Last September, the president's days as leader seemed limited only by his lifespan. They now seem numbered, reports **Charles Clover**

The movement of nations," Leo Tolstoy wrote, "is caused not by power, nor by intellectual activity, nor even by a combination of the two as historians have supposed."

Instead, he said, in one of the most overquoted passages from *War and Peace*, history is made by "the activity of all the people who participate in the events".

While perhaps not the most stunning insight into the human condition, it goes some way towards explaining a shift that has taken place in Russian society over the past six months: the people, after a decade-long hiatus, have once again become a factor in running the country.

While most Russian revolutions tend to be "meaningless and merciless", as the saying goes, this one has for the most part been impressive for its peacefulness (with the exception of a May 6 clash between protesters and police where dozens were injured).

It is unlikely to take on the proportions of the Arab spring or sweep the ruling elite from power in the manner of Ukraine's 2004 Orange Revolution, but it has nonetheless had a profound effect on political life.

For more than a decade since Vladimir Putin came to power in 2000, three factors have dominated Russia's politics.

First, there is Mr Putin, with his strongman style; second the group of ex-spies and security men he brought with him into the Kremlin in 2000, known as the *siloviki* ("strong men"); and third, the oil price, which has behaved as a sort of *deus ex machina,* occasionally intervening from offstage to rain down fabulous wealth or crash the rouble. Mostly the former.

However, that all changed last December, when, following gratuitously rigged parliamentary elections, the largest anti-Kremlin demonstrations since the early 1990s gathered 100,000 protesters.

The size of the marches has shrunk, but the causes of the protests have not – a palpable tiredness with Mr Putin's rule and a new demand for political rights among an emerging middle class.

Marchers seem to feel a new rush of energy following the return to power of Mr Putin on May 7, and on June 12, 50,000 to 70,000 demonstrated in central Moscow for democratic change.

Mr Putin's days as leader, which seemed limited only by his lifespan last September when he announced his return to the presidency, now seem numbered, unless he can reinvent himself as a leader of the newly emerging elite who have suddenly found their political voice.

Tax paying, private sector, internet-savvy workers account for a growing percentage of Russia's population, and it is chiefly from this group that the protest movement is drawn.

They are demanding fair treatment from the state, say observers such as Konstantin Remchukov, editor of Nezavisimaya Gazeta, the respected Moscow daily newspaper.

"They pay taxes, they made it through two economic crises without the state's help and they have decided that they want the state to work for them now. They are fed up with being humiliated," he says.

Some find it ironic that the so-called middle class, who owe their relative prosperity to the Putin era – most were impoverished by economic liberalisation in the 1990s, but saw their incomes nearly triple in the decade of his rule – are leading the mutiny against the Kremlin.

Even among pro-Kremlin commentators, there is a growing weariness of Mr Putin's rule.

Maksim Shevchenko, a television journalist who is a strong critic of the anti-Putin opposition, says: "I consider Putin to be an effective crisis manager who pulled the country out of a crisis in which we were threatened by the collapse of the state. However, I do not consider him to be irreplaceable. He is not the only leader there is."

Many, including Mr Shevchenko, think it unlikely that Mr Putin will seek a fourth term as president. If he ran again in 2018 "I think he would lose".

His current term, says Mr Shevchenko, should be devoted to guaranteeing a democratic process and transition to real elections.

He adds: "Putin needs to be the father of the nation, like [John] Adams or [Ben] Franklin. In the next six years, he needs to formulate the principles of a democratic, free development of this nation. He needs to find a balance between managing the country and allowing it to develop."

There are too many examples, he says, of Russian rulers standing in the way of history. "The Romanov empire collapsed because it was not ready for change".

However, he says anti-Putin opposition leaders such as Boris Nemtsov and Alexei Navalny, have not managed to present an attractive alternative.

"The only alternative they suggest is a restoration of the Yeltsin era, which is completely unacceptable to a majority of the population."

Indeed, opinion polls show that, while people care about property rights, criticise election fraud and corruption, and have ceased to see the Putin Kremlin as sacred repository of the Russian nation, support for "liberal values" is low.

The public distrusts much of the opposition which is too closely associated with the Yeltsin years, known colloquially as the "era of seven bankers", when oligarchs were massively enriched by an insider-driven privatisation process and private property ended up concentrated into a few hands.

Many see only two options: the political system in the hands of a corrupt state bureaucracy, or in the private hands of an oligarchy.

Neither of these inspires confidence in an ability to protect basic rights and property – the hallmark of demands by a newly politicised middle class.

Given the choices, Mr Putin may be the lesser of two evils. He has been working to shore up his popularity with additional government spending (campaign pledges total 1 per cent of Russia's GDP for the next five years, not including a massive defence spending hike), as well as with an assertive foreign policy which has seen Russia play a spoiler role in the midst of the Syria crisis.

While Russia's refusal to endorse UN sanctions against Damascus has been met with international bewilderment and outrage, it has played well in Russia, where voters like to see their leaders standing up to the west.

The president's stance on Syria, defending embattled autocrat Bashar al-Assad from an angry populace, has uncomfortable echos for Mr Putin.

Amid signs of an impending crackdown, the Kremlin has backed down on political liberalisation promised made by former President Dmitry Medvedev last December.

Mr Medvedev's pledges to return elections for provincial governors and fairer registration rules for political parties were watered down by parliament before they were passed.

In one of his first acts as president, Mr Putin then rushed through parliament a law levelling draconian fines on protest violations. Some believe he may have miscalculated and the law will backfire, further aggravating political instability.

The June 12 demonstration, which saw a large uptick in numbers from previous protests, is the first evidence that the regime's hard line attitude may be counterproductive.

Roland Nash, chief strategist for Verno Capital, a hedge fund, says the worst case scenario feared by investors is an overreaction by the Kremlin and a crackdown. "So far, however, they are handling it better than the market feared."

Inside this issue

In-fighting casts doubt on privatisation

Energy

Catherine Belton looks at the power struggle worrying foreign investors

When Vladimir Putin unveiled his new cabinet on May 21, after nearly a month of deliberations, it contained a few surprises. Mr Putin had a trick or two up his sleeve.

Two days later, it was announced he had signed a decree that appeared to potentially take away a large part of the government's control over privatisation of the energy industry.

The decree called for the government to first sell its energy stakes to Rosneftegaz, the state investment vehicle.

The order sowed confusion about the new government's privatisation agenda, an important test of Mr Putin's resolve for reform. Though a Putin spokesman later insisted the decree did not mean Russia was cancelling privatisation plans for the energy sector, it would certainly mean delaying them for several years, potentially beyond 2015.

The move bore all the hallmarks of a power shift behind the red walls of the Kremlin as Russian elites start to fracture, bankers and analysts say.

It also shook the boardrooms of some of Russia's biggest foreign investors. BP swiftly announced it wanted to sell its 50 per cent stake in TNK-BP, the troubled Russian oil venture, potentially plunging the UK oil group into the centre of a new carve-up of power.

Igor Sechin (left), with Dmitry Medvedev, the prime minister

Igor Sechin, a close Putin ally who was deputy prime minister for energy and industry, was left out of the new government amid rivalry with Dmitry Medvedev, who swapped places with Mr Putin to become prime minister.

But Mr Sechin was appointed chief executive of Rosneft, the state oil champion, and was elevated to the Rosneftegaz board, indicating he was going to be in charge of a power structure of his own.

One senior international banker believes the decree gave Mr Putin – and Mr Sechin – ultimate control over how and when stakes in the energy sector are sold.

The decrees have "emasculated the Medvedev government's control over

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Russia

Foreign investors wait to see what government will do

Stock exchange

Markets unconvinced by Putin's rhetoric, says **Catherine Belton**

When Vladimir Putin's new government this month unveiled its latest $9.3bn privatisation plan for 2012, the Russian stock market barely batted an eyelid.

Talk of up to $10bn in dividends and buybacks this year is also not exactly causing investors to rush in, even though such a shareholder payout is unheard of for Russia, which normally trails well behind its emerging market peers in putting money in minority shareholders' pockets.

The problem is that the privatisation programme did not look exactly new. Many investors have heard similar variations before and few doubt it will go ahead as planned because of poor market conditions. And, with other measures announced in the first month of Mr Putin's return to the presidency sending mixed messages at best, most investors are still sitting on the sidelines. So far, there is little sign of the Putin 2.0 some investors hoped for mapping liberal reforms to confound his critics.

"I have rarely seen such an indifferent attitude towards Russia," says one investor.

"His regime has been talking about reform for so long and there has been so little progress, that the attitude is 'come back and talk to us when you're ready to do it'."

So, instead of the hoped-for rally to mark the start of Mr Putin's third term, the stock market remains buffeted by turmoil on global markets.

The eurozone crisis and recession fears are weighing on the oil price, helping propel Russia's RTS index down more than 20 per cent since its March peak.

Russian stocks now average a price of about four times earnings, levels not seen since 2009, when the economy was sliding into a steep recession and many big companies were struggling to stave off bankruptcy and refinance debt in the aftermath of the 2008 global financial crisis, .

Today, the economy is still growing at 4 per cent, Russian companies' balance sheets are far more robust – and though the threat of a big dip in the oil price is never far away, most have reined in their appetites and lowered the amount of indebtedness and risk.

Jacob Grapengiesser, a partner at the Stockholm-based East Capital investment fund, says: "Today, the underlying finances are much better. There's such a big discrepancy between fundamentals and valuations," Mr Grapengiesser says.

"But it is difficult to see Russia perform with all the other problems in the EU and the US. We are going to be victims to outside circumstances."

A big part of the problem is that the Russian market is going to remain extremely vulnerable to outside shocks without a bigger pool of investors.

"There is no strong domestic investor base prepared to buy long term assets," says Chris Weafer, chief strategist at Troika Dialog, the Moscow investment bank. "Right now Russia is completely dependent on attracting foreign investors. But they leave at the first sign of nervousness about anything."

'There is no strong domestic investor base prepared to buy long-term assets,' says Chris Weafer

Fears are still looming about the oil price falling to $60 a barrel, far below the $117 price at which the Russian budget breaks even, and the money that left towards the end of last year after political unrest broke out still has not returned.

"Even though Russia is cheap, there are other countries that are cheaper right now: Greek stocks are priced at about three times earnings," Mr Weafer says. "Spain and Portugal are becoming almost as cheap – and investors still trust them more to get reforms right."

Most investors have put fears about political instability to the back of their minds since Mr Putin's re-election in March – despite the outbreak of violence at an opposition rally in May.

But the growing infighting between Russia's political clans is a worrying sign.

Mr Grapengiesser says:"If you look at the line-up of new ministers in the government, it's very good news.

"There are a lot of younger people such as Arkady Dvorkovich [the former presidential economic aide appointed deputy prime minister in charge of energy and industry]. But the messages coming out of the government and the presidential administration have been difficult to interpret."

Much of the confusion centres on the privatisation plans and control of Russia's energy.

In the same week that Mr Putin announced the cabinet would be largely led by liberal-leaning youthful ministers, he also decreed that state stakes in the energy sector were to be consolidated into Rosneftegaz, the state investment vehicle, controlled by Igor Sechin, the former deputy prime minister in charge of energy, who is a hawkish arch-rival of Dmitry Medvedev, the prime minister.

Though Mr Putin's decree does not fully cancel sales of stakes to the market, as Mr Medvedev had planned, it does delay any such move until after 2015.

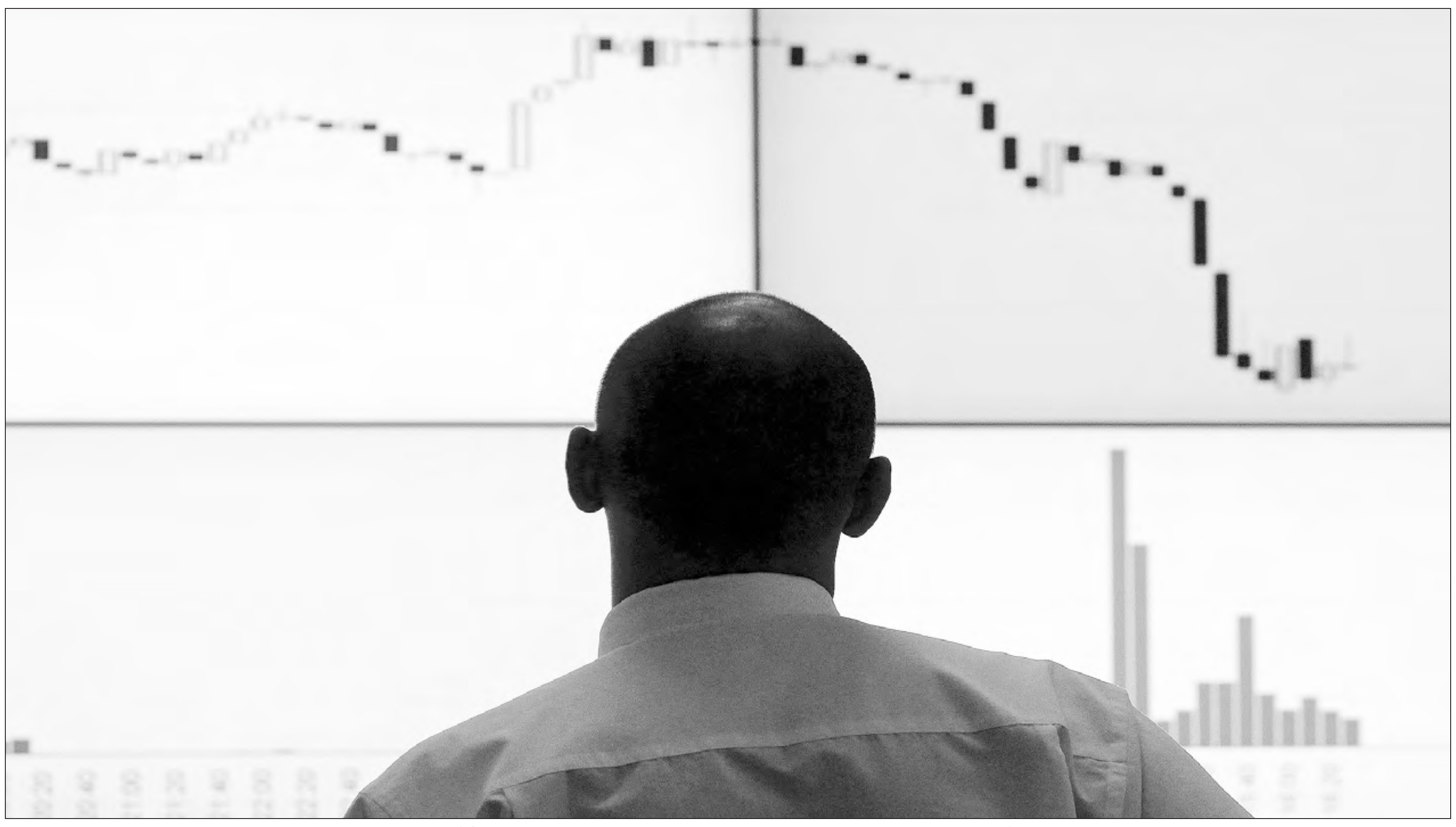
To some investors, this may seem justified because of the turmoil on global markets. But to others, it also looks like a power play, with Mr Sechin using the vehicle to create a parallel government with control of the energy sector.

Alexander Branis, director at Prosperity Capital investment fund, says: "If this happens, Rosneftegaz is going to resemble a state conglomerate and it will cost a lot of time. It will assume control and only later figure out what to do. There will be less transparency."

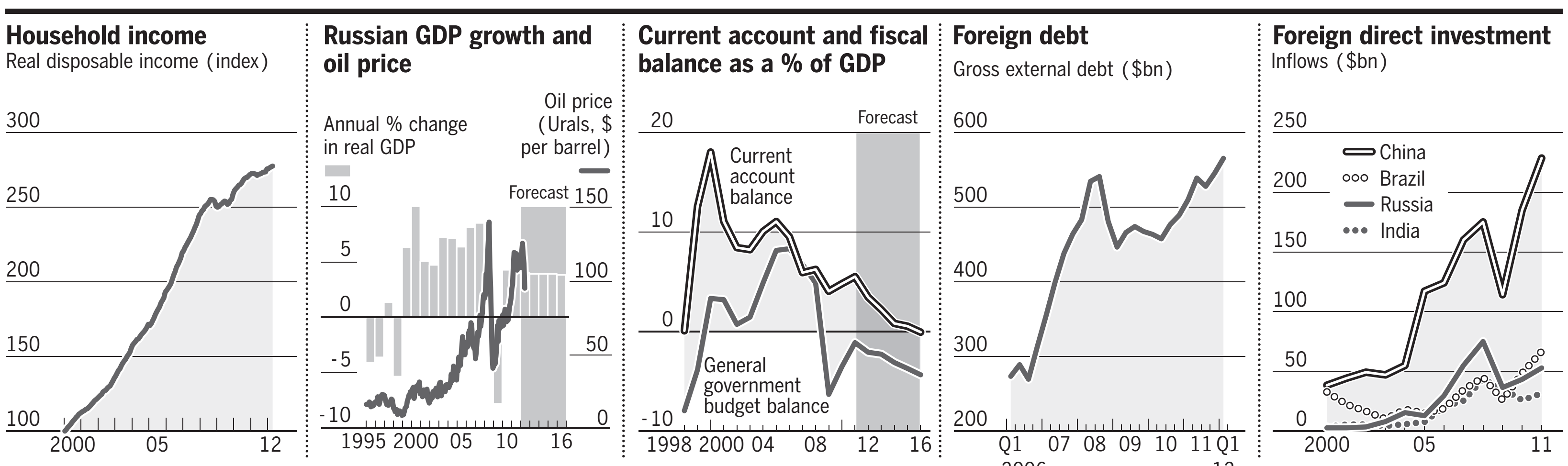
Other moves by the government look more encouraging, with a number of big improvements to the civil code being debated in the state Duma, which should significantly improve corporate governance.

"This is going to be a test of the resolve of the government," says Mr Branis.

But, for now, investors are still waiting. "Until they've seen clearer signs from the government on which way it is going to move, they are going to stay on the sidelines," says Mr Grapengiesser.



Downtime: stock market index has fallen almost 30 per cent since a mid-March peak. The rouble has fallen 13 per cent against the dollar Reuters



Source: Haver Analytics; IMF; Central Bank of Russia; OECD

Oil dependency remains a fundamental weakness

Economy

Structural reform is urgently needed, writes **Neil Buckley**

Moscow's dollar-denominated stock market index is down more than 20 per cent since this year's mid-March peak, while the rouble has fallen 13 per cent against the dollar. Is Russia's economy again headed for a fall?

Investors might be forgiven for fearing it is 2008 all over again.

That year, the stock market began a seven-month, 80 per cent decline from peak to trough, as oil and commodity prices slumped, followed by the collapse of Lehman Brothers in September.

Russia's economy went on to shrink by 7.8 per cent in 2009, the deepest recession of any G20 country.

The recent market slides reflect a 20 per cent decline in Brent crude prices since March, which reached $100 a barrel by early June, and intensifying concerns that Greece could crash out of the eurozone, dealing a Lehman-style shock to the global economy.

But many analysts say the recent falls are an overreaction typical of Russian markets. The country is in many ways less vulnerable to external shocks than it was four years ago, even though it has become ever more dependent on oil prices.

Charles Robertson, global chief economist at Renaissance Capital, the Moscow-based investment bank, says: "In 2008, markets priced Russia as if it was going to offer a repeat of 1998," referring to the 1990s default on domestic debt.

"Now, the markets are pricing Russia like it's going to be 2008 again."

The foreign debt of banks and companies is much lower than it was four years ago, making the economy less susceptible to a sudden halt to financing and the macroeconomic position also looks robust.

Russia has foreign exchange reserves of $500bn, a current account surplus last year of more than 5 per cent of gross domestic product, and public debt below 10 per cent of GDP.

Growth was a respectable 4.3 per cent in both 2010 and 2011, and the International Monetary Fund is forecasting 4 per cent growth this year and next.

Russia can, of course, never be immune. Sberbank, the country's biggest bank, warned last month that, if Greece withdrew from the euro in the final quarter of 2012 in an "unregulated" way, Russia's GDP would contract 2.1 per cent next year.

Renaissance Capital says an "orderly" Greek exit would prompt a modest slowdown in Russia's growth to 2 per cent this year and 2.9 per cent next; a disorderly exit would cause a mild 2013 recession of 0.2 per cent.

If Spain also left the euro, Renaissance forecast that Russian output would decline 2.7 per cent this year and 5 per cent in 2013.

What is notable about all those forecasts is that they are less severe than Russia's 2009 recession.

But some analysts are more cautious. Russia's Higher School of Economics warns that if a global slowdown reduced oil prices even to $80 a barrel, the government would quickly burn through its $60bn rainy-day reserve fund to meet its budget obligations.

> Economists have warned that Russia is drawing too heavily on its energy wealth

Oil dependency is seen as Russia's biggest weakness.

This year's budget needs an oil price of more than $120 a barrel to balance, lifting the non-oil deficit, the shortfall excluding oil and gas revenues, to 12.5 per cent of GDP. It was below 5 per cent before 2008.

Returning president Vladimir Putin, made some costly election promises which totalled about Rbs10tn by 2018, even excluding ambitious military spending increases, notes Sergei Aleksashenko, a former deputy central bank governor, now director of macroeconomic studies at the Higher School.

Oil prices would need to grow by $10 to $15 a year, he adds, otherwise the "budget will not be affordable", forcing Russia to increase borrowing or reduce spending.

Economists have also warned that, with budgetary spending becoming a bigger contributor to growth, and that, in its turn, increasingly funded by oil and gas revenues, Russia is drawing too heavily on its energy wealth.

That drives up prices and costs, crowds out private sector investment and makes manufacturing uncompetitive, all classic symptoms of the so-called Dutch disease.

This hinders what should be its main policy aim: diversifying the economy away from reliance on extractive industries.

Most observers agree the only way to do that is through structural reforms aimed at increasing competitiveness and stimulating the private sector, small businesses, and technology.

Mr Putin has repeatedly said he understands this.

But the market believes that, since his return as president, the signals he has given over his commitment to reforms have been distinctly mixed. However, Anders Aaslund, a Swedish economist who advised on Russia's 1990s reforms and has often been a Putin critic, believes the recent signals have been more positive than investors give credit for. He expects Mr Putin to be hawkish in domestic politics and foreign policy, but to make real efforts on economic reforms. "This is where Putin thinks that he can deliver something, where he can give ground to the liberal groups," says Mr Aaslund.

He highlights an April speech by Mr Putin which set concrete targets – including improving Russia's 120th position in the World Bank's Ease of Doing Business index by 100 places by 2018. Mr Aaslund adds that the newly-appointed government, headed by Prime Minister Dmitry Medvedev, contains more liberal reformers, with greater room for manoeuvre, than is commonly supposed.

But the Higher School's Mr Aleksashenko remains sceptical, warning that Mr Putin tends to ignore the most fundamental problems. "In his articles and speeches, there was not one word about independent courts, about rule of law, about prevention of corruption," he says. "Without these pillars, I don't believe structural reform is possible."

State sell-offs boost competition further down the track

Rail freight

Sales gather pace amid consolidation of private operators, writes **Isabel Gorst**

Russian Railways, the state rail monopoly, has been trundling along the route to reform for more than a decade, spinning off independent transport subsidiaries and slowly divesting itself of its cargo fleet.

Privately owned rail freight operators that have proliferated in the newly liberalised market are racing to buy and sell assets.

Globaltrans splashed out $540m in April to buy the transport division of Russian miner Metalloinvest, in a landmark deal that increased its rolling stock by a fifth.

The London-listed Russian train operator has set a goal of becoming the country's leading freight group and is seeking further acquisitions.

"There has been talk about consolidation of the railway cargo business for some time," says Alexander Eliseev, chairman of Globaltrans. "We have transformed words into deeds."

Russia's sprawling railway network is the backbone of the transport system, carrying more than 80 per cent of the country's non-pipeline freight.

Cargo flows are dominated by oil, coal, iron ore and metals, and are a barometer for Russia's natural resource-based economy.

Since reforms started in 2002, Russian Railways has loosened its grip on freight operations while retaining control of the track and locomotives.

More than 60 per cent of Russia's 1m cargo wagons are now operated by privately owned transport companies.

Industry experts say the market is overcrowded. "There are about 200 independent cargo rail operators. That's too many and very inefficient," says Nikita Melnikov, transport analyst at Aton, the Moscow-based investment group. "A more sensible number would be between seven and 10."

As the railway industry opened up, natural resource producers rushed to buy new wagons to reduce their reliance on Russian Railways' out-of-date fleet.

Metalloinvest's decision to sell its transport division has set the signals for a wave of mergers and acquisitions.

Globaltrans was founded in 2004 by the Russian transport group N-Trans and controls about 60,000 wagons, including the former Metalloinvest fleet.

It uses multipurpose "gondolas" that carry bulk cargoes, while tanker wagons transport crude and oil products.

A big competitor is Universal Cargo Logistics, a transport company controlled by Vladimir Lisin, a Russian metals baron, that has gained strength on the back of railway privatisation.

UCL won a privatisation auction last year of Freight One, paying $4.2bn for a 75 per cent stake in Russian Railways' biggest freight operating subsidiary.

The next big railway privatisation is expected in 2013, when Russian Railways divests itself of a further stake in TransContainer, the London-listed rail boxcar operator.

Neither the scale nor the format of the sale have been determined. Government officials have said that Freight One should be wholly in private hands, but Russian Railways would like to retain a minority stake.

> More than 60 per cent of cargo wagons are operated by private companies

Far East Shipping Company (Fesco), a transport group controlled by Sergei Generalov, a former Russian energy minister, has a 21 per cent stake in TransContainer and has been seen as a frontrunner to win the privatisation.

But in an unexpected move, Fesco said last month it had entered negotiations to sell its business to Summa, the Russian investment and trading group.

Russian Railways has decided to retain control of Freight Two, its other big bulk cargo subsidiary. Train operators bent on expansion have no option but to focus on acquiring rival privately owned fleets.

Rail cargo volumes are recovering from a sharp contraction during the global financial crisis but, at 1.24bn tonnes last year, are still 5 per cent below 2008 levels.

Sluggish growth and higher railway tariffs are forcing train operators to become more efficient and boost economies of scale, says Mr Melnikov.

"Operators cannot drum up business any more, simply by buying [rolling stock] – they must build up cargo flow."

Congestion has worsened, partly as the result of sloppily introduced reforms. Russian Railways, under attack from train operators for faulty dispatching practices, has promised to ease bottlenecks on tracks near export terminals.

Government regulators have stepped in with a range of proposals that would force the pace of consolidation. Among these is a rule that would allow only the largest train operators to transport cargoes nationwide.

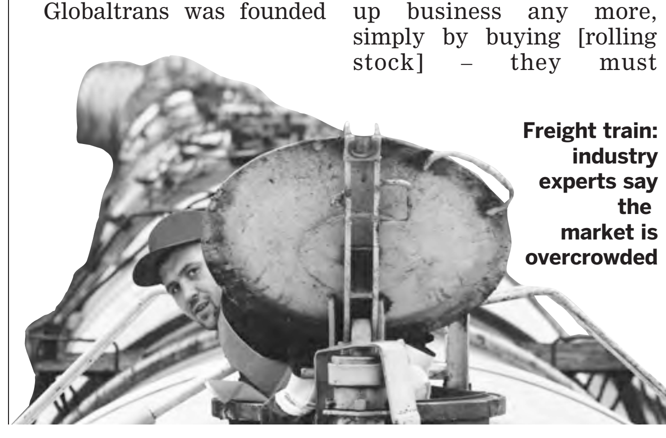
Deepening troubles in the eurozone threaten to undermine the recovery of freight volumes and are intensifying competition in the transport sector.

Mr Eliseev says Globaltrans is shielded against economic shocks by the large size of its fleet and diversified customer base, which includes many of Russia's big oil and metals groups.

The deal with Metalloinvest came with a three-year contract to transport the metals company's goods, bolstering the stability of Globaltrans's business, he says.

Government-backed infrastructure projects under way in Russia are changing the freight landscape, which has traditionally been oriented towards foreign trade.

Rising demand for deliveries of construction materials to domestic sites could soften the blow of a decline in export traffic. Oil exports remained buoyant throughout the 2008-09 recession and are unlikely to fall.



Freight train: industry experts say the market is overcrowded

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Decision making becomes less predictable

Politics

Mr Putin's behaviour has raised a few eyebrows, writes Charles Clover

Speeding towards his inauguration on May 7, Vladimir Putin's motorcade was not lacking in grandeur. The president-elect rode in a sleek limousine with a phalanx of motorcycle outriders, followed by live aerial TV coverage on all federal channels, as studio announcers breathlessly recorded every second of progress towards a glittering Kremlin ceremony.

Only one thing was missing. Instead of throngs of adoring well-wishers lining the road, there was an eerie silence. The procession glided along empty streets as passers-by were chased into courtyards and shops by policemen. The effort to prevent protesters from disrupting the day's festivities meant there were no festivities at all.

For critics of the Kremlin, looking for symbolism at the start of Mr Putin's third presidential term, here was a microcosm of his relationship with society: hermetically sealed from his subjects inside the spaceship-like Kremlin political apparatus.

Critics say his decade-long isolation within a narrow group of confidants – not all of whom have the county's best interests at heart – has begun to affect Mr Putin's decisions, and fed a paranoia that seems to come naturally to former spies and security men like him and who form his inner circle.

Last December, at the start of protests against his rule, he accused Hillary Clinton, the US secretary of state, of "sending signals" to demonstrators. Since then, he has frequently referred to "hidden forces" that are out to depose him and destabilise Russia. At the time, the rhetoric seemed to be mere electioneering, but his fears appear to have increased since his presidential victory in March. Many analysts say his decision making has become perhaps the most unpredictable factor in Russian politics.

"Putin is surrounded by people who are afraid of him or who flatter him," says Alexander Lebedev, the Moscow-based billionaire proprietor of two London newspapers. "He is isolated and it is beginning to show."

On June 8, for example, he pushed a law through parliament that sharply raised fines for unsanctioned demonstrations which the Kremlin's own Council on Civil Society and Human Rights says is probably unconstitutional. Political observers from across the spectrum say the law is not only legally wrong-headed, it is simply overkill. They say he has launched a crackdown against an opposition that presents no physical threat to the regime.

Gleb Pavlovsky, a former close adviser to the Kremlin who was fired last year, says: "The demonstrators are not going to storm the Kremlin or the mayor's office. It is a completely unbalanced decision and only shows how paranoid Putin's circle is, how much he has lost touch with the reality of the political situation," he told Ekho Moskvy, a radio station, this month.

The Kremlin insists the law is similar to those in other European countries and the US, although critics say that much will depend on how it is applied.

Mr Pavlovsky blames Mr Putin's staff for allowing the law to go ahead. "You have to understand that, occasionally, a president will get angry, emotional, and one has to stop him, to calm him down. For this there are aides, advisers, professional staff who can explain the risks and the threats – the international risks, say for the economic situation of Russia – of passing such a law. But no one stopped him."

It was not the only decision that has raised eyebrows. One of Mr Putin's first acts as president was to cancel his participation at the G8 summit in the US, citing a busy schedule. However it was intended, it was seen as a snub made in a fit of temper and taken by many as signalling an imminent break with the west.

Mr Putin has also begun rewarding elaborate displays of flattery and loyalty. In May, he named Igor Kholmanskikh, the foreman in a tank making factory in the town of Nizhny Tagil, as the Kremlin's plenipotentiary representative in the entire Urals region. In December, Mr Kholmanskikh had offered the services of his factory colleagues to Mr Putin during a nationally televised call in December, saying they would come to Moscow to beat up anti-Putin demonstrators "if the police are not capable of taking care of things".

Soon after, he announced that free apartments in Moscow would be granted to four riot policemen who were injured in a fracas with protesters on May 6 (17 of the latter were hospitalised, according to Interfax, the Russian news agency). Oleg Kashin, a journalist for Kommersant newspaper, says the decision made the regime appear isolated and desperate to buy loyalty, and could backfire. "If ordinary riot police now get apartments for their loyalty, then the higher-ups know they can expect entire apartment buildings," he wrote.

Yevgenia Albats, editor of the weekly New Times, the opposition magazine, says the behaviour of the Kremlin is showing the tell-tale symptoms of decline reminiscent of fading authoritarian regimes in Latin America or southern Europe in the 1970s and 1980s.

"This is a common problem in so-called peaceful authoritarian regimes," says Ms Albats, who has a PhD in political science from Harvard University. "In political science, they call this 'information asymmetry', when people at the top make mistakes because they don't have good information from the ground. They are surrounded by people who are taking advantage of them, who need to secure jobs, money, and favours. These people know that their jobs depend on delivering good news to the Kremlin. We had exactly the same under the Soviets," she says.

However, others say Mr Putin is simply a cunning political operator and his new, populist and paranoid style is simply the result of transformed political calculations.

In contrast to the protest movement, which involves mainly urban, private sector workers who rely for information on the internet, the so-called "Putin majority", is mainly outside Moscow, relatively poorly educated, dependent on the federal budget for its incomes, and derives most of its information from state television.

Among this group of people, Mr Putin's approval scores are rising, says Valery Fyodorov, head of Vtsiom, the polling agency. Overall, Mr Putin's popularity scores have not fallen since election-time highs, though other agencies report a drop. "He is relying intensively on his core constituency," says Mr Fyodorov. "He is no longer the president of all Russians, only president of the majority, and he is focusing on them."

Vyacheslav Nikonov, a parliamentary deputy from Mr Putin's United Russia party, says looking at politics from Moscow inevitably warps one's perspective, and Mr Putin's presentation is directed mainly at "Russia outside the [Moscow] ring road".

"Most of the rest of Russia couldn't care less about the opposition," he says. This sentiment is backed up by opinion polls that show anti-Kremlin feeling concentrated in a few urban centres, with the rest of the country mainly loyal. A western diplomat also dismisses the notion that Mr Putin is "losing the plot", as Mr Pavlovsky puts it. "He is a very smart operator and he knows what he is doing."

Staff trouble: 'Putin is surrounded almost exclusively by people who are afraid of him or who flatter him,' says Alexander Lebedev, the billionaire businessman Getty

Better productivity is seen as driving future growth

Efficiency

Charles Clover looks at efforts to boost GDP

By 2020, Russia's government hopes real gross domestic product will double from its 2010 level, putting the country in the top five world economies.

However, just how to accomplish that feat is hotly debated.

Plans for creating a high-tech innovation sector are unlikely to come to fruition for another 15 years, according to venture capitalists, while few believe oil prices will quadruple once again, as they did in the past decade.

Meanwhile, the Kremlin is unlikely to be able to raise foreign investment in the current climate without drastically improving governance.

That leaves one alternative: Russia has to become more efficient.

The bad news is that it is at present one of the most inefficient economies in Europe, if not the world.

But that can also the be seen as good news, as there is much room for relatively inexpensive improvement.

"Making the Russian economy more efficient mostly just takes effort," says Irene Shvakman, a senior partner in McKinsey's Moscow office. "It is a way to grow without requiring huge amounts of new investment."

The most generic measure of productivity is GDP per capita, which in Russia is 70 per cent lower than in the US. In most other measures, too, the country is well behind the more advanced economies.

In energy, it is likewise one of the world's least efficient countries. A unit of GDP requires twice the energy input as in China, and six times that of the US. Meanwhile, capital investment in projects such as roads and power plants is 30 to 50 per cent more expensive than in the EU and multiples of what it is in China.

Only in industries such as retail, with low barriers to entry and high foreign participation, does labour productivity approach world standards.

Ms Shvakman says it is not obvious that privatisation by itself helps spur efficiency gains.

Some of Russia's most advanced companies are state-controlled (she will not name names).

On the other hand, some of the worst performing companies are also state controlled (again, no names).

"It's not about state-controlled versus private," says Ms Shvakman. "It's more about 'Do I have an enlightened leader or management team who want to push productivity in a holistic way?'"

Overall, she says, many of the largest companies are bringing in improvements in capital investment, cutting out needless layers of management, standardising operating procedures and centralising operations.

Many companies that used to have human resources and finance and accounting departments in all branch offices now have these functions conducted centrally.

Many cities outside Moscow with comparatively low labour costs, such as Tver and Ryazan, are home to thriving call-centre and back office service industries, allowing companies to outsource entire departments.

The biggest obstacle to further improvement, Ms Shvakman says, is the nature of regulations in many sectors. These sometimes create disincentives for making productivity gains and also focus management attention on lobbying and regulatory activities.

As a result, she says, there are more gains to be made by lobbying the government than there are in making enterprises more efficient.

"If you're a manager and you see it is most effective spending your time walking the corridors of power, then you will do that," she explains.

Overall, McKinsey estimates that labour productivity must increase by 6 per cent a year in order to hit the 2020 growth target.

This is particularly imperative as, according to studies by Rosstat, the state statistics agency, the labour force could fall by 12 per cent by 2020.

Improving productivity also requires capital investment, and Russia has pledged to raise investment as a percentage of GDP to 25 per cent by 2020, from less than 20 per cent at present.

This compares with a 30 to 40 per cent level in other emerging markets such as China and India.

Infrastructure presents a serious bottleneck. The road network, for example, expanded at 4 per cent a year in Soviet times, but, under Mr Putin, it has effectively stopped since 2000.

Measured in kilometres, roads have nudged up from 754,000km in 2000 to 776,000km in 2009.

That is a quarter the rate of increase that was seen even in the economic crisis years of the 1990s. In the World Economic Forum's competitive rating, Russia gets 130th place for road quality, below Angola, Kyrgyzstan and Tajikistan.

At the same time, the vehicle fleet has grown by an average 5 per cent a year since 2000.

Increasing investment would be made easier by improving the efficiency of capital spending. Part of the reason for limited road building is the expense: a kilometre of road costs an average $10.5m compared with $4.3m in the EU and $1.3m in China, according to a report this year by the Forum.

With a huge infrastructure deficit, the cost of building a combined heat and power plant (CHPP) is $2,500 per kWh of capacity, compared with $1,800 for the EU and $720 for China.

The cost of building a distribution centre in Moscow, meanwhile, is €945 per square metre, 34 per cent higher than in London. Some of these greater costs are due to high labour costs, climate and transport distances. But a fair portion is due to "leakage". In a detailed study by McKinsey up to 30 per cent of the cost of building a power plant was "unexplainable".

"There is no good reason for the cost of building in Russia to be this high," says Ms Shvakman.

Retail is the only sector that is close to world standards Getty

Shoppers resolutely ignore global turmoil

Retail

Spending surges but weaker rouble may act as a brake, says Courtney Weaver

While investors may be concerned about the fallout from the eurozone and the gyrations of the oil price, worries about global instability have been slow to reach Russian consumers.

A demographic known for spending when the going gets tough, Russian shoppers have thus far defied expectations of a slowdown.

Supported by a spurt in retail lending from the country's banking sector, consumers are continuing to spend on high-end goods such as cars. They are even lending support to nascent industries such as online retail, a sector that once appeared to have too many logistical barriers.

Russians had little reason to cut back on discretionary spending – travel, high-end goods and electronics – in the first half of the year, given the relatively strong state of the economy, which registered 4.9 per cent growth in the first quarter, according to Rosstat, the state statistics service.

Historically, Russians are known for spending rather than saving in uncertain times.

In December 2011, Moscow faced unprecedented street protests and the country's stock market recorded a double-digit drop in the space of a week.

Regardless of all this, consumer spending in the days before New Year rose 16 per cent year-on-year, according to Romir, the research group. Rosstat put the increase for the month at 9.3 per cent.

It is too soon to tell how the rouble's recent depreciation will affect sentiment.

The currency dropped 12 per cent against the dollar in May, and could fall further this year if the oil price continues to decline.

Nonetheless, analysts are optimistic that Russians will keep spending, despite the world's problems, noting the delayed reaction consumers have shown thus far to global events.

Natasha Zagvozdina, deputy head of research at Renaissance Capital, the investment bank, says: "Even though the European story is not giving us many reasons to be optimistic, Russia looks a lot more immune [to a crisis] than it did in 2008-2009 as far as consumer behaviour is concerned."

Retail sales rose 7.5 per cent year-on-year in the first quarter, according to Rosstat, and 6.4 per cent year-on-year in April – the most recent period for which data are available.

Ms Zagvozdina says consumers' positive perception of the economy could be hit by the recent depreciation of the rouble – "a sign for the consumer that maybe it is time to slow down".

However, she adds that, given the trends in the first half of the year, it is unlikely consumer spending will drop precipitously.

Consumer lending has been growing steadily. At the end of March, non-housing consumer lending had risen 8.9 per cent for the year to date.

The loans, in many cases, are going towards bigger purchases, such as cars, with people choosing to upgrade rather than wait for the global market outlook to improve.

> While Russia was once seen as hostile ground for ecommerce, this mentality is starting to change

According to early data from the Association of European Businesses, car sales are likely to return to pre-crisis levels this year, fuelled by demand for high-quality Japanese and German vehicles. "It is the middle class that is spending and upgrading their cars," Ms Zagvozdina says.

As Russia's relatively young middle class continues to develop, another area that is likely to grow is online retail.

While Russia was once seen as hostile ground for ecommerce, given the size of the country and relatively poor state of the postal service, this mentality is starting to change.

Giedrius Pukas, founder of Quadro Capital Partners and a seasoned investor in Russia's retail sector, compares sceptics to investors who thought Russians would not be able to afford mobile phones in the early 2000s. Those who took this view missed out on the market's lightning-fast growth.

"Ecommerce in Russia has huge potential," he says. "But there are two bottlenecks that have to be unblocked. There is a lack of proper infrastructure and there is no proper system for money collection."

Ozon, Russia's answer to Amazon, has already started to overcome both these barriers, says Maelle Gavet, the company's chief executive.

The company's dedicated delivery service, O-Courier, now delivers to 130 cities and operates more than 2,000 pick-up points. Easier access for customers has led to an increase in sales. Last year, revenue at the company grew 78 per cent in rouble terms to $302.5m.

While Ms Gavet says Ozon could suffer in the event of further depreciation of the rouble, as it would increase import prices for the goods the company sells on its website, she believes online retail will probably be affected less in the long run than offline retail.

"In general, online stores have lower prices than offline. Thus, during the crisis period, customers will turn to online more," she says.

Joint venture knows where it is going

Profile
NIS Glonass

The operator of navigation satellites seeks commercial opportunities, says Courtney Weaver

From a public relations standpoint, 2011 was not an easy year for Russia's space industry. A $265m communications satellite crashed into the Pacific; a cargo flight failed to reach astronauts in orbit; and a probe sent to Mars's moons, the country's first interplanetary mission, also crashed before leaving Earth's orbit.

Yet the year also marked a significant achievement: the restoration of Glonass (an acronym for global navigation satellite system), Russia's rival for the US's Global Positioning System (GPS) satellite array. The task took a decade and cost about $2bn.

Conceived in the 1970s and originally completed in 1995 and operated for the Russian government by the Russian Aerospace Defence Forces, Glonass ceased to function properly at the end of the 1990s because of lack of resources.

Now it is operational again, with 24 satellites in constellation, and has the potential not just to boost the image of the Russian space industry, but to help global navigation. Using Glonass in conjunction with GPS should improve accuracy.

At the forefront of this is NIS (Navigation Information Systems) Glonass, a public-private partnership that seeks to make the navigational system commercially viable by finding non-military applications.

The launch of three satellites meant to complete the network in 2010 failed, pushing back completion by a year. But Alexander Gurko, NIS Glonass chief executive, says the company is now ready to develop portable navigation devices for customers ranging from oil and gas companies to mobile phone users.

Owned by the government and Vladimir Yevtushenkov's holding group, AFK Sistema, NIS Glonass is responsible for a new automatic emergency response system called Era-Glonass that will be mandatory for all new cars in Russia from 2014.

Once installed, the company says, Era-Glonass will be able, in the event of an accident, to transmit information about the vehicle, its owner and position to a regional data centre within milliseconds, potentially saving 4,000 lives a year.

The product is one of many that is designed to improve Russia's vast infrastructure, Mr Gurko says. "We are building intelligent transport systems for big cities in Russia – very complex projects that will really improve the lives of citizens," he says.

In public transport, this means a fleet-management system that will monitor which buses are on the road and where, and transmit this information to waiting passengers. For the police, a similar system will allow dispatchers to send the closest police car to a crime or accident – a system already in use in Moscow.

From next year, Glonass will be used to improve the country's vast road network through a new toll system. "You have to build additional infrastructure to [improve] the road network," Mr Gurko explains.

"It's much easier to equip 1.5m heavy trucks with navigation devices and charge money based on the kilometres they cover. With electrical transportation coming, it will be the only way to collect taxes and money. It won't depend on the size of your engine – only on the route you cover."

While Russian infrastructure looks to be a natural market for NIS Glonass, the company may have a tougher time with international consumer goods manufacturers, which need to be convinced it is worth giving their products Glonass capability.

It took GPS manufacturers 10 years to make their products accessible to consumers in the form of chip sets for mobile phones, for example, says Stefane Chenard of Euroconsult, a consultancy specialising in the satellite market.

Glonass's limited history does not help, says Jonathan Beland, an analyst at US-based Futron, the consultancy.

"GPS has two decades of reliable operation. Glonass has had one year so far since it fell apart in the 1990s. The Russians need to prove they can maintain their system as well as the Americans," he says.

Despite this, Mr Beland says that adding Glonass should ultimately work to manufacturers' advantage, something that some western companies have already recognised.

"Having access to another global satellite navigation system in addition to GPS improves precision, accuracy and reliability, and Glonass is the only other system with global coverage.

"Certain western manufacturers are building Glonass capability into their devices, Apple's new iPhone being a prime example."

Mr Gurko is well aware of the difficulties and believes the new, "very active" Russian government is too.

With Glonass fully in place, NIS Glonass needs to focus on what the top commercial applications for the technology will be, and make developing those applications a priority.

"We need a more focused approach. It's not possible to develop all the technologies of the world simultaneously," Mr Gurko says.

"We need a more focused policy and more concrete results in a short period of time."

Lift-off: a Proton-M rocket launches Glonass satellites

Marriage of old and new in deluxe market

Weddings

Nouveau-riche adopt western styles – and add a few of their own, writes Isabel Gorst

Among the skyscrapers going up in Moscow's new business district is one that was inspired by August Rodin's sculpture "The Kiss". Designed by the global architects RMJM, the twisting tower represents a groom with his bride whose veil will trail down 46 storeys to a register office on the ground floor.

"Moscow City planners are not romantic, they're pragmatic," says Katerina Agronik, the founder of Select Cake Studio, maker of party cakes for the Russian elite. "Weddings are becoming big business."

Russia's budding wedding industry does not yet compare in size to that of the US, where the business is worth more than $40bn a year.

But as Russians get richer and more cosmopolitan, the western craze for elaborate, painstakingly planned weddings is spreading.

Luxury retailers have jumped on the bandwagon and the wedding services sector is developing.

About 1m couples in Russia tie the knot each year at weddings that are usually small and more boisterous than ceremonious.

In a throwback to the Soviet era, the big day begins in a queue at the register office, where brides and grooms wait listening to Mendelssohn's wedding march.

After the ceremony and a few glasses of bubbly, the wedding party departs in a procession of cars to visit the local second world war memorial and other historic sites before retiring to a restaurant for a banquet. Festivities continue long into the night. It is seen as a sign of good luck for the newlyweds if a drunken brawl breaks out.

The children of the Russian oligarchy have grown up rich and travelled widely and dream of sophisticated weddings that will set them apart from the crowd.

Ksenia Samoilenko, who runs a boutique events planning agency in Moscow, says: "Before, it was enough to have a white dress and lots of food and alcohol. Now, people want something more: a sense of high society and good taste. It's very competitive." All her clients are on the Forbes billionaire list.

As Russian weddings become grander, former Tsarist palaces are getting a new lease of life.

Some, such as the Pashkov house, an 18th century mansion overlooking the Kremlin, offer a complete service, including not just banquets and dancing but civil ceremonies on the spot.

No more register office queues and less Mendelssohn; at many upmarket weddings, international stars are hired to sing.

Revelries often continue for two to three days with food and alcohol constantly on tap.

Western caterers such as Hedier, the French gourmet retailer, have broken into the luxury wedding market with menus tailored to Russian tastes.

Ms Samoilenko says small portions fashionable in the west do not go down well at Russian weddings. "Russians like to eat and drink a lot. It's important that the table is laden."

Presentation is also important, with custom-made silverware, embroidered napkins and lavish decor all de rigueur.

The cake, the most important item after the bride's dress in the west, has been no more than an afterthought at Russian weddings.

But Ms Agronik spotted the gap in the market and, after training under Sylvia Winestock, the US "Leonardo de Vinci" of wedding cakes, opened a party cake business in an industrial park outside Moscow in 2008.

Her Select Cake Studio decorates cakes to order, sculpting flowers, Fabergé eggs and comic figures, out of icing sugar.

Bride and tested: a young Russian woman tries on a wedding dress in an upmarket salon in Grozny Reuters

At society Russian weddings, the arrival of the cake, brought into the party by "a procession of waiters in a blaze of firecrackers" has become a central event.

Customer relations require careful handling, as rich Russians are not trusting and tend to take secrecy to extremes. Clients roll up in eye-catching cars for cake planning sessions, but often do not volunteer their surnames.

In one spooky photograph of a cake-cutting ceremony sent to Ms Agronik, the happy couple's heads had been airbrushed out.

Luxury retailers are benefiting, as Russian weddings grow more extravagant.

Traditionally, guests give flowers to the bride and groom but, as influence spreads from the west, many are now shopping for more durable presents as well.

To catch the tide, Villeroy & Boch, the German-owned porcelain manufacturer, and the French bed linen company Yves Delorme have introduced bridal lists at their Moscow stores.

In Soviet times, brides used to run up wedding dresses on sewing machines, but now the rich have the pick of foreign designer gowns. Pro Nuptia, the international wedding dress retailer, has opened outlets across the country.

For most brides, a white dress is no longer enough, they need accessories as well.

Joins & Co, a bridal footwear retailer, imports white satin stilettos from China. Sales have grown 30 per cent a year since it opened in 2002 and are now $2m a year. Oleg Zenchenko, general manager, says: "There were no bridal shoes here when we started."

"The wedding market is only just beginning. It's very exciting doing business in Russia."

> Festivities continue long into the night. It is seen as a sign of good luck for the newlyweds if a brawl breaks out

In-fighting casts doubt on privatisation prospects

Continued from Page 1

energy", he says. In his first presidential term, Mr Putin advocated the creation of a state energy giant and analysts say Rosneftegaz could become akin to Saudi Aramco if state stakes are consolidated under it.

Rosneftegaz already holds a 75 per cent stake in Rosneft and could raise its 10 per cent stake in Gazprom, the big gas producer, as well as expand into the electricity sector.

One official says Rosneftegaz could boost the capital of any constituent energy companies before selling them off. "This builds a bridge between a government-owned company and a private sector enterprise and that bridge is going to be Rosneftegaz", the official says.

He noted that Rosneftegaz could then boost the capital of any constituent energy companies before selling them off.

This would enable the state to receive "budget proceeds from privatisation, regardless of market conditions, and put into place an active corporate shareholder structure clearly focused on capitalisation and upcoming privatisation", says the official.

Mr Sechin, who oversaw the controversial state takeover of Mikhail Khodorkovsky's Yukos nearly 10 years ago, had lobbied strongly to delay energy privatisations for most of the year so that poor market conditions would not threaten the security of the strategically important sector.

That pitted him against the ambitious, more reformist agenda of Mr Medvedev, who was still intent on reducing the state's role in the economy via large scale privatisation.

Many Moscow analysts now predict that Rosneftegaz will wind up the buyer of BP's 50 per cent stake, with the UK oil group potentially receiving cash and shares in Rosneft or Gazprom in return.

The shift was further strengthened last Friday when Mr Putin's spokesman announced that a special commission is to be created for the development of the industry. Mr Putin is to chair the commission, while Mr Sechin will be its secretary in chief. "This can only confirm the correct suspicion that a parallel government structure is being set up," a state official says.

But others say the battle for Russia's energy sector is far from over. One sign that Mr Medvedev's government is still fighting for control is that its own government order changed the wording of Mr Putin's decree from saying Rosneftegaz "is" the buyer of the state stakes to saying Rosneftegaz "could be" the buyer of the state's energy stakes.

Arkady Dvorkovich: stakes would be transferred 'if expedient'

"This is a sign of real conflict," says one state official. "The government is directly contradicting the presidential decree. This just doesn't normally happen."

The nuanced differences in the wording took on further emphasis when Mr Medvedev unveiled his privatisation programme in early June.

Arkady Dvorkovich, the new deputy prime minister for energy and industry and a close Medvedev aide, said stakes would only be transferred to Rosneftegaz if it were "expedient".

Mr Medvedev concurred, saying that "the government will decide", despite Mr Putin's decree giving the presidential administration control over the process. A few days later, Mr Sechin held a surprise meeting, with the nation's oil barons for the inaugural session of a new oil club.

The meeting was held just hours before the sector titans were to meet Mr Dvorkovich for the first time, according to one person familiar with the matter.

The shifting sands are leaving foreign investors nervous. The most worrisome part of the decree concerned the future of two power utilities, FSK, the national power grid, and MRSK, the main power distribution holding.

Concerns are growing that if stakes in the two companies are consolidated into Rosneftegaz, it could add weight to proposals that they be merged, as Mr Sechin has advocated.

Chris Weafer, chief strategist at Troika Dialog, says investors could live with a delay in energy privatisation given the turmoil on global markets, "as long as it doesn't prevent faster reform in other parts of the economy".

But other analysts fear any stand-off over the sector's future could escalate into broader instability as infighting grows.