



Eyes on the presidential prize: Dmitry Medvedev (left) has recently been laying the ground for his candidacy, while Vladimir Putin insists it is too early for an announcement about next year's election

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Rivalry at the top causes unease

Charles Clover notes the change in atmosphere in the run-up to an election whose outcome is unclear

Mikhail Osokin, anchor of an opposition-oriented news programme on Russian television channel REN TV, says he can reliably tell an election is coming by the tone of the government's calls to him and his editors following his shows.

"It's an atmosphere, like a feeling on your skin," he says. "In an election year, there is a chill. Everyone is a little more nervous. And this year, everyone is a little more nervous than in most election years."

Russian journalists are like canaries in a coal mine – the first to feel a change in the political atmosphere. And what is making people jumpy this time is that, with less than a year before the 2012 presidential election, the outcome is not yet widely known – which is unsettling in a country that prizes predictability.

The main question is no longer whether Dmitry Medvedev will stay for a second term, or whether Vladimir Putin will return to the presidency from his current role as prime minister – this has always been tempered by the widely held view that, whatever happens, it will be part of a well-rehearsed plan decided in the smoky back rooms of the Kremlin, a stitch-up between the two men.

Now, however, the uncertainty is over whether there actually is a plan, or whether the outcome will be left to the personal ambitions and relative power of each man and his entourage.

"I really don't think they [Mr Putin and Mr Medvedev] know who is going to be president," says Mr Osokin. "And no one else knows either."

Over the past month, Mr Medvedev has begun laying markers for his own presidential ambitions, to the obvious displeasure of his predecessor, sparking talk of a rift between the two.

In March, Mr Medvedev chastised Mr Putin, calling his remarks on the Libyan war – which the latter had compared to a crusade – "unacceptable".

Then, in April, he forced one of Mr Putin's most trusted lieutenants, Igor Sechin, a deputy prime minister, to step down from his post as chairman of Rosneft, the state oil company, with a decree prohibiting

ministers from holding seats on the boards of state companies.

On April 12, he issued his boldest statement yet, indicating that he could stay on. "I do not rule out that I will run for a new term as president. A decision will be made, moreover, in the fairly near future, because there is less than a year remaining," Mr Medvedev told Chinese state TV on the eve of a visit to Beijing.

Mr Putin, meanwhile, seems to be pushing back against Mr Medvedev's pugilistic tone. The day after Mr Medvedev's challenge, Mr Putin told journalists that either of them could still run in 2012, and it was too early to make any announcements about the election.

Infighting in the Kremlin is nothing new – Winston Churchill famously compared Soviet politics to watching "bulldogs fight under a carpet". And reading the tea leaves today is reminiscent of Cold War style Kremlinology, when armies of CIA analysts, with little else to go on, pored over the seating arrangements of the May Day parade bandstand.

One official close to Mr Putin cautions journalists about making too much of the recent squabbling – both the prime minister and the president have an interest in keeping everyone guessing, he says.

The moment one of them becomes the candidate, the power of the other would be reduced. "Neither wants the other one to be a lame duck," he points out.

But there are signs that the uncertainty is having a real effect. Despite near-record prices for oil and a seemingly healthy economy, nervous Russians have taken a net \$21bn out of the country in the first quarter, according to the central bank.

Meanwhile, when Mr Medvedev and Mr Putin publicly disagreed over the war in Libya, parliamentary deputies tried to avoid taking sides, perfecting the art of "sitting on two stools", as the Russian saying goes.

Most people still believe that the decision on the presidency rests with Mr Putin "but it's not clear that he wants it", according to the editor of a Moscow daily newspaper. "There is a view that he is just tired of the whole game."

There is more to Russian political life, though, than what happens inside the Kremlin. There are increasing signs that the electorate is fed up with the two choices on offer. A study by the Center for Strategic Research, a think-tank with

close links to the United Russia political party, says focus groups have expressed increasing disapproval of the ruling duo.

"The change in the political consciousness of Russians that has occurred in recent months is not only diminishing confidence in the Putin-Medvedev tandem, but fuelling demand for a new leader, a third leader," the report says.

The rise in discontent is a conundrum. The price of oil, the usual barometer of Russian economic health, is above \$120 a barrel and climbing. Inflation is near its lowest in two decades, though rising. Bank credit is growing, and deposits have surged 30 per cent since the crisis two years ago, a sign of renewed confidence.

Investment is also growing. Officials say their goal is to raise investment as a percentage of GDP from 20 per cent now to more than 30 per cent over the next decade, chiefly by attracting foreign investment.

Recent deals have underlined this, such as PepsiCo's acquisition of Wimm-Bill-Dann, and the announcement of a \$10bn government fund to invest alongside foreigners in private equity-type deals.

"We need to make progress in improving the investment climate," says Arkady Dvorkovich, a Kremlin economic adviser, who calls a trend towards liberal economic reforms "a very positive signal".

He recently met western bankers and economists to hear their views on what Russia can do to make itself more attractive to foreign investors, in an openness to foreign opinion not seen for years.

However, one key indicator is doing badly – real wages, which doubled in less than a decade under Mr Putin until 2008, but have

barely risen in the past two years.

Yitzhak Brudny, a Russia specialist at the Hebrew University of Jerusalem, says the rising discontent indicates that Mr Putin is a victim of his own success. In the Putin years, Russians became used to steadily improving living standards.

"[Former President Boris] Yeltsin put expectations down, so it was easy for Mr Putin to meet them in his first years," he says. "Now, expectations are much higher."

Much of Russia's mood of protest is being funnelled into ethnic nationalism: in

December, Moscow witnessed the largest violent disturbances since 1993, as skinheads rioted outside the Kremlin walls on Manezh Square. A poll in January by the Levada Center, a sociological research agency, showed that 58 per cent of Russians support the slogan "Russia for the Russians", the highest number since data began to be collected in 1998.

It is difficult to predict how the new protest mood will affect calculations in the Kremlin. Mr Medvedev has been positioning himself as the candidate for the disaffected, but his appeal

is limited to a narrow liberal audience. Further disorder and a descent into nationalism would favour the return of Mr Putin.

The Kremlin, long used to throwing money at problems – Mr Osokin calls the practice "stuffing people's open mouths with cash" – has found that this approach may for the first time spawn more inflation and ultimately be counter-productive.

"They can't step into the same river twice," says Mr Brudny. "There is a real sense that they have already tried everything, and are out of ideas."

Success in 'near abroad' is main achievement

Foreign policy

Modernising the economy is the new focus, says Neil Buckley

Foreign policy is an area where Russia's president Dmitry Medvedev and prime minister Vladimir Putin have clashed in recent weeks.

But analysts suggest that, while the clash, after Mr Putin likened western air strikes in Libya to medieval "crusades", may have reflected genuine differences of opinion, it did not signal any change in Moscow's more pragmatic foreign policy line.

Russia's decision to abstain at the United Nations over the resolution

allowing western action in Libya, rather than wield its veto, is the latest evidence that foreign policy, like the economy, has entered a new, third phase in the country's post-Soviet history.

The 1990s saw Russia attempting to put relations with the west on a new footing, but experiencing a large decline in influence.

The next decade, under Mr Putin's presidency, saw a more aggressive Russia attempting to claw back its lost clout. The culmination of that second phase was Russia's 2008 war in Georgia.

While the intervention drew condemnation in the west, it achieved the unstated aim. Russia's invasion persuaded members of the North Atlantic Treaty Organisation to think hard about the consequences of admitting Georgia, or

Ukraine, to membership of the military alliance. It pushed any such plans off the west's agenda for the time being.

"Since 2007-08, Russia has reached a level where it is satisfied with its great power status. It wants to keep on enhancing it, to play the games, but it isn't revisionist any more," says Sergei Karaganov, head of Russia's Council for Foreign and Defence Policy.

The global financial crisis also forced Russia to rethink foreign relations.

As made clear by a leaked foreign ministry document last May, confirmed in a speech by Mr Medvedev in July, its new approach is to use foreign policy to further Russia's goal of modernising its economy.

Moscow should have "no friends, or enemies, only interests". It should form "modernising partnerships"



Trenin: help from US 'reset'

with countries such as Germany, France, Italy and the US.

"If you think that overcoming your backwardness is your most important challenge, then your foreign policy is a facilitator," says Dmitri Trenin, director of the Carnegie Moscow Centre.

There had been signals of a new approach well before last summer, aided by Washington's "reset" of relations. "It very much helped that Barack Obama was elected president," says Mr Trenin. "It removed all the main irritants."

Russia's own "reset" of its external relations had

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Russia

Siberia waits for a thaw in border policies

China-Russia relations

A sparsely populated region needs its neighbour, says **Rachel Morarjee**

Across the Amur river that divides Russia from China, dark streaks of water run in patterns across the ice as spring comes to the Siberian city of Khabarovsk.

The thaw is bad news for Russia's economy but good news for Vova Losev, who works for a trading company that shuts down during the spring and autumn when the ice is too unstable to bear the weight of trucks but still thick enough to obstruct the passage of boats.

"We have two months a year where we can't get much done, but it's nice to have a break from the phone ringing day and night," says Mr Losev, a young Russian who works in neighbouring China.

Along a 3,279km stretch of border from Grodokovo near Vladivostok to Zabaikalsk near Lake Baikal, there is not a single crossing that is passable all year, hampering the growth of trade between resource-rich Russia and the booming Chinese economy.

That should change this year, with construction of a railway bridge across the Amur river to connect the steel mills of Heilongjiang in north-eastern China with the iron ore deposits in Russia that they need to run.

The bridge will be paid for by both the Chinese and Russian governments and by IRC, a Hong-Kong-listed mining company that operates the Kimkanskoye and Sutarskoye (K&S) iron ore field at the Russian end of the railway line.

"We know that Russia needs to cooperate with another country to open up its far east. The natural partner is China, which has far more financial resources than either Japan or South Korea," said Boris Krasnojenov, metals and mining analyst at Renaissance Capital.

The region's key challenge – and one it shares with developing countries with natural resources from

Africa to Mongolia – is infrastructure, says Mr Krasnojenov. And China has the funds to solve the problem.

China is keen to solve that problem to ensure it gets vital resources to power its economy. The project financing for IRC's K&S project was arranged by China's ICBC bank and the China National Electrical Engineering Company (CNEEC), which will build the iron ore processing plant.

At the K&S field, a drill is boring holes to fill with dynamite, and the white powdery explosive dusts the ground around the machine ready to blow a hole in the earth that will expose the iron ore beneath.

"We use Chinese workers to develop the mine. It's a win-win for everybody," says Svetlana Kostromitina, a mining analyst with Petropavlovsk, which owns a controlling stake in IRC.

Ms Kostromitina has identified the other key challenge confronting officials trying to develop the remote but resource-rich Siberian forest which borders China – a lack of people.

With thousands of miles of unexplored forest and snowy tundra, Russia's far east is sparsely populated. It has only 6.7m people spread across its vast area, or roughly one person a square kilometre, compared with 84 per sq km in the Chinese province of Heilongjiang across the Amur river.

"There is enormous potential here, but the key challenge is to find the personnel you need to open up the region," says Ken Tocker, product support manager at Amur Machinery and Services, a subsidiary of Caterpillar of the US, which supplies the trucks, drills and diggers that power the mining, timber and construction industry in Russia's far east.

In two decades of working for Caterpillar in 20 countries, Mr Tocker says this is the toughest posting he has had. He has tried to recruit people from central and western Russia to work there and failed. "It's practically impossible," he says.

Despite the lack of manpower in eastern Siberia, however, Russia has not made it easy for Chinese citizens to emigrate and work in the region.

Russians can cross the Amur river from the border city of Blagoveshensk



Difficult crossing: the Amur is impassable two months of the year

Alamy Images

to the Heihe free-trade zone, on the opposite side, without a visa. But Chinese are not able to make the same journey travelling in the opposite direction.

Meanwhile, in the Russian city of Khabarovsk, a 18-hour train ride away through the dense birch and cedar forest known as the taiga, the authorities reduce the populations of Chinese migrant workers by carrying out spot checks and deporting those caught without papers.

But without Chinese labour the region will languish.

Dr Pavel A Minarkir, director of the Russian Academy of Sciences Far East branch, says that the region's

best hope is to align more closely with its Asian neighbour.

"We are not Europe and we are not Asia, but the political obstacles to a closer economic relationship with north-east Asia are far lower than those standing in the way of integration with the European Union," Dr Minarkir says.

China's projected growth of 7 to 9 per cent a year is correlated with steel demand, so iron ore is a vital element supporting the Chinese economy.

The countries remain locked in a tight but uneasy embrace. But for Siberia, Chinese money and workers will be vital to push the economy forward.

Financial reform Rise in credibility is overdue

To many foreign investors, President Dmitry Medvedev's plans to transform Moscow into an international financial centre able to compete with other regional hubs look like little more than a pipe dream, writes **Catherine Belton**.

With a corrupt judicial system and many other investment risks, most Russian companies seek to raise long-term capital on international exchanges. Most of Russia's billionaires also keep their fortunes offshore, while Moscow's financial infrastructure lags far behind the rest of the world.

But this year, at the Russian president's bidding, the government has begun taking concrete steps to create a financial system that is not so easily buffeted by global financial shocks, as Russia seeks to diversify its economy away from commodities.

"There is a growing realisation in the government that some kind of enduring reform of the financial and judicial system is needed, because currently the rate of capital outflow is unsustainable," says Chris Barter, co-chief executive of Goldman Sachs in Russia.

Outflows hit \$21bn in the first quarter of the year. That continued a trend begun in September, which saw about \$3bn in net outflows per week, as jitters grew over political stability and possible tax rises.

However, in recent months Mr Medvedev has begun stepping up efforts to boost the credibility of the financial system. In March, he called for all companies and regulators to adopt international financial reporting standards. He also signed off on a decree to merge two financial market watchdogs.

Moscow's two exchanges, the RTS and the Micex, are also to merge after months of negotiations in a move that should simplify market infrastructure, while the Kremlin has studied an advisory council for financial centre reform with leading lights of the investment banking world, including Lloyd Blankfein, chief executive of Goldman Sachs, Jamie Dimon of JPMorgan Chase and Steve Schwarzman, co-founder of Blackstone.

But the government needs to do a great deal more if Russia is ever going to have a thriving financial centre of its own and bring back any of the hundreds of billions of dollars held by Russian tycoons in Swiss bank accounts, bankers say.

"A lot of oligarchs say they are happy to make money in Russia, because the return on capital is much higher. But once they've made it, they want to bank it offshore," says another senior western banker.

"Whether this situation changes will depend on whether a lot of institutions

improve, including whether there is a credible judicial system."

One big step towards boosting the stability of the financial infrastructure would be to bring a large part of the credit market onshore, bankers say.

Currently, many Russian tycoons borrow money by pledging shares in Russian blue-chip companies against loans – a practice known as "margin lending". However, it brought the country's bourses to a halt in autumn 2008, when margin calls on loans exacerbated already falling markets and caused the regulator to shut down the markets or face a total meltdown.

"It is an offshore market because no one believes in enforceability onshore," says Mr Barter. "It is challenging to regulate offshore leverage and hence monitor its future impact on the market." That means Russian exchanges could easily face a repeat of the credibility-damaging "death spiral" of 2008.

But to bring margin lending onshore, contracts need to be enforceable, which means "you need to have an arbitration system that works", Mr Barter says.

Russia would also need to deepen



'Unless we start using Russian law on major deals, the legal system will never improve'

Dimitry Afanasiev

its own pool of domestic capital by finally embarking on pension reform, a policy likely to be delayed beyond presidential elections next year, analysts say.

Another helpful step would be for the Russian government to use a Russian exchange rather than London to sell some of the state assets under its \$30bn privatisation programme.

In the background, leading Russian lawyers are working on ways to boost the credibility of the legal system. Dimitry Afanasiev, chairman of Egorov, Puginsky, Afanasiev and Partners, says his firm is heading a group working on rewriting the civil code to improve the enforceability of contracts and bring Russian legislation in line with international standards.

"Unless we start using Russian law on major deals, the legal system will never improve and it is a vicious circle," Mr Afanasiev says. "Otherwise, there will be no pressure on the courts to improve and the legal system will remain inefficient."

But whether progress is made or not could depend on whether soaring oil prices sap the government's sense that it needs to act. "This is a real concern," a banker warns.

Sugar trader comes up roses in an unfriendly climate

Horticulture

Isabel Gorst describes how an unlikely commercial idea has flourished

Deep in the Russian countryside, the white hothouse merges into the snow, concealing the forest of exotic roses inside.

"In a way it's crazy to grow hothouse flowers in the cold," says Florence Gervase d'Aldin, the horticultural company that has introduced rare garden roses to Russia. "If I had understood what it would mean, I would have been afraid."

Russia is the world's sixth biggest market for cut flowers,

importing about \$2bn worth of blooms a year, mainly from industrial growers in Kenya and South Africa.

But frail garden roses cannot be carried across long distances, because they wilt within three days of being cut. Voluptuous and highly perfumed, these rare flowers caught on quickly in Moscow when Feya Roza began trading in 2008. Clients include a string of luxury florists, Chanel, Cartier and the residence of Dmitry Medvedev, the Russian president.

A love of flowers is embedded in the Russian culture, reflecting a yearning to escape from the long colourless months of snow. So, when Ms Gervase d'Aldin grew tired of her career trading sugar in Russia, the flower business seemed like a bright idea.

"I was bored," she says. "Someone suggested rose-

growing and I just switched on."

With financial backing from a group of Russian and foreign investors, she began searching for land, eventually choosing a place in the Kaluga region, 250km south-west of Moscow.

There is no tradition of agriculture in Kaluga, let alone the scientific horticulture that is required to grow hothouse flowers. But the local authorities had a reputation for openness even to experimental investors – Volkswagen and Peugeot have vehicle assembly plants in the region and a local oligarch is trying to grow Aberdeen Angus beef.

Rural land is cheap in Russia, but Ms Gervase d'Aldin agreed to pay above the market price for a 15-hectare plot outside the tumbledown village of Babulino to ensure her hothouse was guaranteed water and electricity supplies. While many foreign

investors give top jobs to expatriates, she hired a Russian managing director with close ties to the Kaluga authorities.

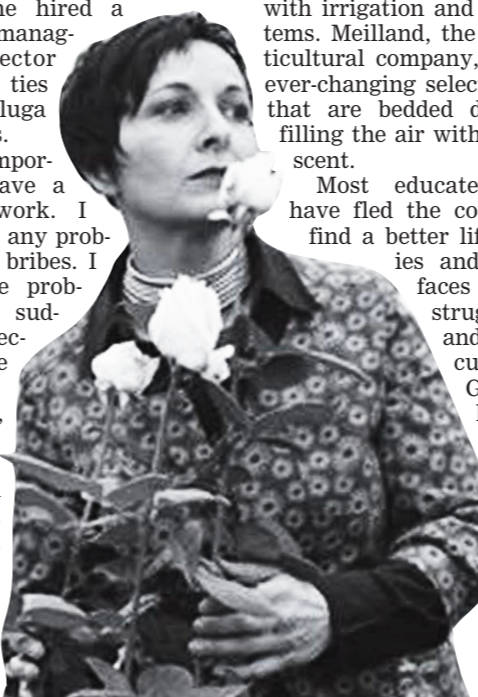
"It is important to have a local network. I don't have any problems with bribes. I don't have problems with sudden inspections," she says.

So far, Feya Roza has invested about €6m mainly on imported technology, in-

cluding a hothouse equipped with irrigation and heating systems. Meilland, the French horticultural company, supplies an ever-changing selection of roses that are bedded down inside, filling the air with their heady scent.

Most educated Russians have fled the countryside to find a better life in the cities and Feya Roza faces a continual struggle to find and train horticultural staff.

Garden roses look naturally beautiful in a vase, but they are grown artificially.



Business hothouse: Florence Gervase d'Aldin

A love of flowers is in the culture, reflecting a yearning to escape the long colourless months of snow

cially on a diet of mineral nutrients drip fed into "hydroponic" gravel beds. "We made a lot of mistakes at first," says Ms Gervase d'Aldin. "If you get things wrong with roses, they die. It's much more difficult than sugar trading where problems are solved by phone."

Another challenge is that energy prices have been deregulated this year causing the hothouse electricity bill to soar and workers to demand higher wages.

"Nothing is done to help small businesses in Russia," she says. Feya Roza sells about 2,000 roses a week in Moscow and 10 times that amount around national holidays.

Demand for flowers in the capital is recovering from a fall during the crisis, but it is still difficult to find reliable retail partners to care for the roses and charge reasonable prices.

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Success in the 'near abroad'

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seen it resolve a 40-year maritime border dispute with Norway and embark on a historic rapprochement with Poland.

This strengthened after April's Smolensk air crash in which Poland's president Lech Kaczynski died along with many senior figures.

Yet some question how much Russia can gain from its new policy. Local commentators point out that previous phases of post-Soviet policy began with attempts to build partnerships with the west.

President Boris Yeltsin in the early 1990s sought a new start, but Nato pushed ahead, against Russia's wishes, with expansion into the former Soviet bloc.

Similarly, President Putin was the first foreign leader to phone US president George W Bush after the 9/11 terrorist attacks in 2001. He quickly allowed the US to use bases in former Soviet republics to support its invasion of Afghanistan.

Yet according to the Rus-

sian narrative, the US snubbed Mr Putin's initiative, withdrawing months later from the 1972 Anti-Ballistic Missile treaty against Russia's objections and later backing "coloured" revolutions in Georgia and Ukraine.

Alexei Pushkov, a foreign relations professor and presenter of a political TV show, says that other countries' decisions on whether to co-operate commercially or invest in Russia depend little on political relations.

Foreign investment, he adds, peaked in 2007-2008, when talk of a "new Cold War" was at its height.

"Following the end of the Cold War, you can have a complex political relationship, and business ties don't depend on this," he says.

Mr Pushkov suggests the US "reset" is a tactical measure aimed at securing Russian support for future action against Iran, and could easily be reversed.

There is also the question of how much the west is prepared to allow Russia a "sphere of privileged

interest" in the former Soviet republics.

While the US and allies have been embroiled in Iraq and Afghanistan, Russia has made big progress in efforts to reassert influence in its "near abroad".

President Mikheil Saakashvili, leader of Georgia's 2003 Rose Revolution, remains in power. But Ukraine's 2004 Orange Revolution has in effect been reversed, with the election of Russia-leaning Viktor Yanukovich – defeated candidate in 2004 – as president in February last year.

Russia has recently been pushing Ukraine to join a customs union it launched last year with Belarus and Kazakhstan.

Kyrgyzstan, which has a more pro-Russian administration after Kurmanbek Bakiyev, president since a 2005 revolution, was ousted last year, formally applied to join the customs union this month.

Little by little, Russia is rebuilding relations, not just with the west but with many of its former Soviet neighbours.

Contributors

Charles Clover
Moscow Bureau Chief

Neil Buckley
Eastern Europe Editor

Isabel Gorst
Central Asia
Correspondent

Catherine Belton
Moscow Correspondent

Rachel Morarjee
FT Contributor

Rohit Jaggi
Commissioning Editor

Steven Bird
Designer

Andy Mears
Picture Editor

For advertising, contact:
Samantha Lhoas
Phone +44 (0)20 7873 3708
e-mail
samantha.lhoas@ft.com
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Shift in focus puts former spies out in the cold

Politics

The days of the 'strong guys' holding the reins of power may be numbered, writes Charles Clover

Flipping through a sheaf of papers with a breezy air, Arkady Dvorkovich, a bookish-looking Kremlin economic adviser, began reading a list of names at a press conference on March 31.

Suddenly, muttering in the audience stopped. Then jaws started to drop, eyes widened, and Mr Dvorkovich had everyone's full attention.

Some of the most powerful names in Russia were on that list: ministers, deputy prime ministers, all were being told by presidential decree that they must step down from the boards of state-owned companies they had in effect run as fiefdoms for years, to be replaced by independent state representatives.

Then Mr Dvorkovich came to one name in particular. "Rosneft - Sechin," he said and, without pausing, hurried on.

Igor Sechin, deputy prime minister, and until recently reckoned to be the third - or even the second - most powerful man in Russia after Prime Minister Vladimir Putin, was being told he must step down as chairman of the board of state oil company Rosneft.

After the economic adviser was finished, the assembled journalists erupted in frantic chatter. What was going on?

Mr Dvorkovich, a Duke University-educated intellectual, known principally for his encyclopedic statistical memory and formidable chess skills, was firing Mr Sechin, who has been dubbed in the Russian press the "Darth Vader" of the Kremlin, and whose biography reads like that of a John le Carré villain except a lot more vague?

Mr Sechin, a former "military interpreter" in Angola in the 1980s, had formerly epitomised the rise of Russia's officer caste into politics, the now ubiquitous *siloviki*, literally, the "strong guys". The word refers to a group of former spies, security men and soldiers who flooded



Looking to new skills: Arkady Dvorkovich and Dmitry Medvedev AFP/Getty Images

reform of boards of state companies "sends a very serious signal" that Russia is embracing a more liberal governing model.

Another place where liberals may be seen making a comeback is in parliamentary elections this year.

Liberals were shut out of parliament in the 2003 elections, with no liberal party winning enough votes to pass the 5 per cent barrier to representation in parliament. But now, the state may need liberals in parliament to back economic reforms - "and take the blame for them later", jokes Yitzhak Brudny, a specialist on contemporary Russian politics at the Hebrew University in Jerusalem.

One Kremlin official backed this view when talking to journalists in early April, describing the possible formation of a centre-right liberal party before the elections later this year. "It is felt that there is a certain vacuum which could be filled by such a party," he said.

Alexander Oslon, a president of the Moscow-based Public Opinion Foundation, a sociological research agency which has worked for the Kremlin, likewise says: "There is a huge number of Russians who are not represented on the political scene. They are the ones who react positively to the word 'innovation'; they like their iPads, they spend a large part of their lives on the internet, and speak some English. These people exist, and no one expresses their interests." However, he doubts whether such a party could be formed before the December elections.

The balance of the liberals and *siloviki* in the government crucially depends on Mr Putin, especially the decision, which will be largely up to him, on whether he returns to the presidency in 2012 or allows Mr Medvedev another term.

"I don't think Putin has made up his mind," says the editor of a Moscow newspaper.

But the main argument in favour of a third term is simple: "What else is there for him to do? He cannot simply leave, like George Bush, and write his memoirs."

into power with Vladimir Putin when he assumed the presidency in 2000.

But now, after a decade in power, they may be on their way out, and their influential role is increasingly being taken by their counterparts, gleefully dubbed the *slaboviki* (weak guys) in the Russian press - former economists, lawyers, and bankers whose liberal views increasingly seem to triumph over the statist conservatism of the Kremlin's former hierarchs. "The numbers tell the story," says Olga Kryshchanovskaya, a sociologist and member of the ruling United Russia political party, whose academic speciality is studying trends within the Russian elite.

Her latest research shows that the ranks of the *siloviki* in government and state structures have been thinned by nearly half since the high-water mark of 2007, when 67 per cent of the

positions in the executive branch were filled by former spies and security men - including Mr Sechin. Overall, the number is now just over half that - 36 per cent in the Kremlin, while in government the *siloviki* have fallen from 37 to 27 per cent.

"They are uncomfortable in the role as leaders. It was not something they were familiar with," she says. "They are used to the number two or three position, controlling things from behind the scenes, serving the state rather than being the state."

The *siloviki* arrived on the scene in the late Yeltsin years, when the break-up of Russia following the first Chechen war was taken seriously as a threat - some provinces were repudiating foreign treaties, one governor even threatened to take control of nuclear weapons stationed in his province if fed-

eral budget subsidies were not granted on time.

But after a decade of rule by Mr Putin, first as president, now as prime minister, the challenges facing Russia are not political stability but economic growth, following the collapse of 2008-2009. GDP growth is still sluggish, and real wages have barely grown since 2008.

"[The *siloviki*] have fulfilled their mission, which was to prevent the collapse of the state," says Ms Kryshchanovskaya, "Now, a new group of people is needed with new skills."

It was Mr Putin's own decision to all but appoint Dmitry Medvedev, a lawyer, as his successor in 2008 that led to the exodus of many *siloviki*. The trend accelerated because of the sputtering economy - which has brought about a new wave of liberal reforms, such as a privatisation programme designed to raise \$30bn over five years, and

The 'siloviki' in power

Percentage with experience in law enforcement or special services

Branch of power	Year	Overall	Just special services*
President's administration	2007	66.6	37.3
	2010	36.4	25.5
Government	2007	37.2	22.1
	2010	27.1	14.1
Governors	2007	16.6	7.1
	2010	7.2	1.2

Source: Olga Kryshchanovskaya

* FSB and SVR

the reform that cost Mr Sechin his position at Rosneft - along with the jobs of 17 other ministers.

Mr Medvedev champions a departure from the cosy state capitalism that characterised much of the past decade and was associated with the statist *siloviki*. On April 12, he told journalists that state representatives should no longer be "wearing out their pants" on the

boards of state companies, and that the end of Putin-era state capitalism is nigh. "What worked 10 years ago may not work today. We need to get used to a changing world," he said.

Mr Dvorkovich himself, asked about the departure of the former officers from the state and state structures, said it was "an oversimplification" to describe this as the fall of the *siloviki*. Nonetheless, he said the

State-backed groups distort a slowly recovering sector

Banking

Private and foreign groups find it hard to compete, says Catherine Belton

From his corner office on the 57th floor of the Federation Tower in the ultra-modern Moscow City business complex, the view for Andrei Kostin, chief executive of state-controlled VTB bank, seems limitless.

After the financial crisis sent its accounts into the red, Russia's second-biggest bank expects to report record profits of \$1.7bn for 2010.

On the promise of a continued surge in profits, VTB sold a 10 per cent stake to investors for \$3.3bn in February. Now it has just nailed a big new acquisition, a controlling stake in Bank of Moscow, which will give it access to 9.5m additional depositors in Moscow's lucrative market. "Now I'm thinking: what's next?" Mr Kostin says.

For many Russian banks, the recovery from the 2008 and 2009 financial crisis, which wiped out profits and all but paralysed lending, is well under way. Russia's central bank forecasts 20 per cent lending growth this year after total lending rose 12.6 per cent last year. Profits are up across the board, with net profit for the entire sector nearly tripling last year to \$19.5bn as lending recovered, according to the central bank.

But the huge surge in profits comes from an extremely low base. Meanwhile, lending growth - even if it hits 20 per cent this year - is not sufficient to fuel a much-needed deeper economic recovery in sectors outside commodities, say bankers and analysts.

"Lending is picking up, but it is still lower than before the crisis. There is still a lot of uncertainty," says Ekaterina Trofimova, bank rating director at Standard & Poor's. "GDP is

picking up in Russia, but it is mainly driven by high oil prices and commodities, while many other sectors feel pretty bad."

Oleg Vyugin, chief executive of MDM Bank, one of Russia's biggest private lenders, says he expects lending growth this year to be 10 to 15 per cent - lower than the central bank forecast.

"In reality, only very few banks are stepping up lending, especially the state ones," Mr Vyugin says. "For now, the economy is growing at extremely measured rates and investment is also growing slowly."

"On the one hand, there is no big demand for bank loans, and on the other banks don't want to give credit to companies that have low demand for their products."

Even though S&P estimates that problem loans - including restructured loans and foreclosed assets - across the sector have fallen from 40 per cent at the height of the crisis to 25 per cent, this figure is still high enough to make many banks think twice before extending new funds to small and medium-sized

enterprises, Ms Trofimova says.

Despite high oil prices, the Russian economy appears to be struck by a crisis of confidence, with many jittery about the global economy and the political situation at home.

Andrei Klepach, the deputy economy minister, this month decried a "big breakdown" in investment in the first two months of the year, causing the ministry

"Only very few banks are stepping up lending, especially the state ones"

to cut its forecast for investment growth this year from 9 to 6 per cent.

Oleg Danilin, head of banking services in Moscow for Ernst & Young, the consultancy firm, says many Russian banks being pressed by investors to increase profits are concentrating on giving short-term funds to well-known borrowers rather than providing much-needed project

finance for new equipment and production capacity. "The biggest unsatisfied demand is for project financing," he says.

Mr Vyugin agrees: "At the moment, all the banks are chasing the same well-known borrowers." For those low-risk borrowers, state banks are able to price many privately owned competitors out of the market, after receiving huge capital injections from the state.

Many foreign banks are also feeling the squeeze from the increasing dominance of the three main state banks - Sberbank, VTB and Gazprombank - which now account for about 60 per cent of the country's banking assets.

"It used to be hard for Russian banks to compete with foreign bank lending. Now it's the reverse," says Bob Foresman, head of Barclays Capital in Moscow.

Moves by regulators in the west to enforce more stringent regulations on capital ratios have increased the cost of capital for western banks, he says.

"For the biggest transactions, Russian corporates still require foreign bank participation."

Indeed, the growing reach of the likes of VTB is prompting fresh fears that their domination may eventually lower the quality of risk management.

"The growth of the state in the sector is a movement backwards," Mr Vyugin says. "Only fair competition can guarantee the growing quality of services." Private lenders could be squeezed out of the market, he adds.

Ms Trofimova of S&P says: "There is still room for private banks, because the level of intermediation in the economy is still not high. It's still not critical. But as the state banks grow, the problem will become sharper."

Mr Kostin, however, is unrepentant. Referring to VTB's recent acquisition of Bank of Moscow, he says: "It is not the case that we, the grey wolf, VTB, gobbled up the white lamb."



Acquisitive: VTB has bought into Bank of Moscow Bloomberg

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Russia

Policymakers start to grapple with a lack of options

Economy

Voters are being asked to look beyond the current high oil prices, says Neil Buckley

The direction of Russia's economic policy has become perhaps the central debate in the country today – and one intimately linked with the question of who will be president after next March's elections.

The short-term economic outlook is reasonable. A recent surge in oil prices to above \$120 a barrel caused by Middle East unrest could boost growth this year by about 1 percentage point from previous forecasts, to 5 per cent.

If current prices are maintained until the end of the year, moreover, Russia's budget could balance, despite big increases in spending in recent years. The government had planned a defi-

cit of 3.6 per cent of gross domestic product, assuming an oil price of \$75 per barrel.

Inflation, running at 9.5 per cent in February, is perhaps the biggest near-term problem – especially in the run-up to elections, a time when sensitivity among ordinary Russians to rising prices is particularly high.

Both President Dmitry Medvedev and Prime Minister Vladimir Putin have taken steps in recent months to rein in rising fuel and food prices.

In the longer term, however, Russia's economic direction is deeply uncertain. The country's near 8 per cent contraction in 2009 as a result of the financial crisis – the deepest recession among the Group of 20 leading economies – highlighted its excessive reliance on oil, gas and metals.

Assuming that oil prices drop back to about \$75 a barrel, Russia is unlikely to muster annual growth of more than about 4 per cent in coming years. That is not disastrous, but it is well

below many other emerging markets, and below the levels needed to catch up rapidly with advanced economies.

It might also not keep pace with the increases in social spending and pensions required to support its aging population.

In essence, it could represent a return to the stagnation that many Russians remember from the Brezhnev era in the 1970s.

Over the past 18 months, Mr Medvedev has associated himself heavily with the idea that radical steps are needed to modernise the economy and break the reliance on oil. He has called repeatedly for Russia to develop high-technology sectors and a more innovative economy.

He has also founded Skolkovo, a business park outside Moscow, intended to be a kind of test bed for his economic vision and intended to become Russia's answer to Silicon Valley in the US.

A thinktank linked to the president, the Institute of Contemporary Development, last

month published a 96-page programme aimed at Russia's presidential election, presenting the debate in apocalyptic terms.

Russia, it said, did not face a choice merely "between directions in which the country can move, but rather between the country's future and the absence of such a future".

Implicitly backing Mr Medvedev, it suggested that Russian voters next year must choose between "the beginning of change and the end of hope, between the future and a new stagnation".

But Mr Putin, seen as having more conservative economic instincts, on December 30 convened his own taskforce to advise him on policy options. It is headed by respected liberal economist Vladimir Mau, long an associate of post-Soviet reformer Yegor Gaidar, and Yaroslav Kuzminov, rector of Moscow's Higher School of Economics.

Some involved in the taskforce and its 21 working groups

suspect that Mr Putin wanted a proper understanding of the challenges before deciding whether to run for president again. The taskforce will report in full this year, and its conclusions are expected to be similar to those of the Medvedev-linked institute.

Mr Mau says Russia needs to "understand that the economic policy of the previous period is exhausted. We can't compensate for the failings of institutions through [spending] money any more." There is little room for Russia to improve further the efficiency of its legislation without improving the institutions that enforce and adjudicate on the laws, he adds.

Mr Kuzminov says Russia has no chance of becoming a low-cost manufacturer like China, because wages are too high.

Levels of higher education in Russia – which have increased since the Soviet collapse – also make Russians unwilling to work in factories. They do, however, provide an opportunity to

develop a more knowledge-based economy.

"Russians, with their high levels of education, are not prepared to work like robots. They don't want to sit and drive trolleys," Mr Kuzminov says.

Ultimately, however, simply making it easier for existing businesses to operate may be as important as developing new technologies.

Yevgeny Gavrilin, chief economist at Troika Dialog, the investment bank, says Russia still has plenty of scope to secure growth through encouraging small businesses, and through productivity improvements in its biggest existing companies.

Despite the many obstacles such as red tape and corruption, he says, Russia's economy has been doing a pretty good job at "spontaneous modernisation", as Mr Gavrilin puts it.

He says: "A better institutional framework is what is needed to secure more sustainable, faster growth."



'We can't compensate for the failings of institutions through [spending] money any more'

Vladimir Mau, Economist



A reflection of increased affluence: Russia's wealthy among the yachts on show at last year's Millionaire Fair in Moscow

AFP/Getty Images

Offshore havens losing allure for a rising tide of billionaires

Wealth management

The prospect of greater stability is changing long ingrained habits, reports Rachel Morarjee

Two years after Russia's economy hit rock bottom amid the global economic crisis, things are back to normal by at least one indicator – the country's number of billionaires.

Russia boasted 114 dollar billionaires at the end of last year, more even than in its previous boom year of 2007, when it had 101, according to Finans magazine, which publishes an annual list of Russia's richest people.

The boom in the extremely wealthy has spawned a rise in the private banking and wealth management industry. This is becoming tailored more to Russians who want to keep their wealth at home.

Russia's elite have tended to keep their money offshore in safe havens such as Switzerland and the UK, but long-term trends show they are starting to keep more and more at home. "People are still scared to keep all their money onshore, because they are worried about the political environment. That will change as there is more stability," says Alexey Ischenko, head of wealth management at Aton Capital, the Russian investment bank.

Russian banks saw deposits grow by 30 per cent in 2010, according to the central bank, sending a strong signal

of public confidence in the banking system in the aftermath of the financial crisis.

"Cash is flowing back into Russia and it's our job to catch it," says a private banker with a leading western high-street institution.

PwC, the professional services firm, estimated in 2009 that rich individuals kept no more than 10-15 per cent of their wealth with private banks and asset managers in Russia. However, the size of that onshore wealth management market was \$20bn-\$25bn, more than double its size in 2006, despite the financial crisis, PwC estimated.

Furthermore, PwC estimated market growth at 15 per cent in 2010, and local asset managers expect double-digit growth to continue this year and next.

"This is a potential bonanza," says Catherine Thibaut, Swiss-born but hired by local investment bank Troika Dialog as its head of private banking in late 2010.

She estimates that there is \$90bn in liquid assets in Russia and that only 10-15 per cent is invested at the moment. By 2013, Troika Dialog expects the pool of liquid assets to grow to \$245bn.

Aton Capital concurs, saying that before the Russian stock market crash of 2008 there were about 140,000 dollar millionaires in the country. Market losses cut that number to 90,000 but the number is rising rapidly again.

"Our business is growing very fast. People want to play the Russian stock market and they want their advice onshore," says Mr Ischenko.

Most of the wealth management

business is currently centred on Moscow, with private bankers jetting to visit clients in St Petersburg.

But Troika Dialog and Credit Suisse both say that there is a lot of money to be unlocked in the regions, and they plan to expand across Russia.

"People really want local knowledge and expertise and don't want to have to travel hours to get it," says Troika's Ms Thibaut.

However, one Swiss banker says privately that building networks in small Russian towns is a nightmare. "There is usually only one decent hotel and restaurant, where you are seen meeting your clients and then they want to drive you to your next meeting to be

'Our business is growing very fast. People want to play the Russian stock market and they want their advice onshore'

hospitable, which makes discretion impossible. Most people feel much safer talking about money in Moscow where they are not under scrutiny."

Local Russian banks with VIP clients, international retail banks such as Citi, international investment banks such as UBS and Russian asset management companies such as Troika all occupy slightly different niches in the market. However, at every level, relationships between the bankers and their clients are vital.

"What we are offering is a bespoke service. I think that our financial

advisers are almost like a private doctor. We are privy to many sensitive things, from the client's psychology to their vacation plans," says Mr Ischenko at Aton.

Russians increasingly want to have financial advice on their own doorstep. Even Swiss banks that manage their clients' money entirely offshore are appointing advisers in Moscow who can offer an international standard of service to clients on their home ground.

"You cannot simply rely on clients flying to Switzerland once a year," says Michael Kunzi, of Lombard Odier, a Swiss bank. He has worked in private banking in Russia for the past decade.

The market has great potential, but is still handling the small portion of assets that wealthy Russians are willing to book onshore.

"Many of the billionaires who own local banks do not put their cash into their private banks, but hold it separately in private companies," says Mr Kunzi.

Retail banks in Russia will be in a very good position to develop private banking business by identifying the big accounts, and segregating them into a department with better management, he predicts.

"The bottom-up approach could allow retail banks to skim off the cream. As they already have a retail operation, they can allow clients to pay bills and do their ordinary banking in Russia," says Mr Kunzi. "Because they already have an ATM network and the licence to offer physical cash, they have a huge advantage."

Foreign investors fund ventures into risky terrain

Oil and gas

Western companies still want stakes, despite earlier setbacks, says Isabel Gorst

Total, the French oil group, last month bought a minority stake in Novatek, the Russian gas independent, in a deal greeted as further evidence of the Kremlin's new openness to foreign energy investors.

It was nonetheless a bold step for the French company, which has had its share of setbacks in the quest for Russian oil and gas reserves.

Total agreed to pay \$4bn for 12 per cent of Novatek and pledged to increase its stake to 19.4 per cent within three years, cementing a relationship with the Russian company which, although dwarfed by Gazprom, is one of the world's biggest gas producers.

In a separate transaction, Total plans to take a one-fifth share in Novatek's Yamal liquefied natural gas project, one of Russia's most ambitious energy schemes.

Political turmoil in the Middle East and north Africa has intensified international oil companies' resolve to make headway in Russia, where upstream deals have so far been difficult to win and retain.

For once, there is a confluence of interests. Russia wants to remain the world's biggest energy producer, but understands that it needs help from foreign oil companies to extend into the more difficult areas that will sustain future growth.

Chris Weafer, chief strategist at UralSib, the Moscow-based investment bank, says: "Realistically, Russian producers do not have the technology or experience to go it alone in new environments such as the Arctic, and therefore need the partnership of international majors."

Total's agreement with Novatek was the third big foreign investment pact this year for Russia, following a clutch of exploration deals signed by state-run Rosneft with BP and Exxon-Mobil.

Like the others, Total won the personal blessing of Vladimir Putin, Russia's prime minister, who oversaw the signing of the agreement with Novatek at his mansion outside Moscow.

On the surface, the oil industry appears to be flourishing in Russia, where production rose last year to a post-Soviet record of 10.1m barrels a day. But the gains mask an accelerating decline in west Siberia, the most

prolific oil province, that is forcing investors to venture into even more remote and difficult terrain. Russia has vast gas reserves but needs to move ahead with difficult Arctic LNG projects that will help globalise its gas trade.

Rosneft has been the biggest beneficiary of a seven-year bout of resource nationalism in Russia that now appears to have run its course. The state oil company snapped up assets as the Kremlin dismantled the Yukos oil corporation in 2004-05 and won rights to strategic oilfields legally barred to foreign investors.

Gazprom also took advantage of the times, muscling Shell out of the lead role in the Sakhalin II project in 2007, thereby securing a stake in the flagship LNG project that has allowed Russia to diversify into Asian gas markets.

Russia is opening its doors to foreign companies to help sustain production in the longer term, but will offer only "a specific opportunity set", including LNG and Arctic and frontier exploration, says Hilary Cameron, principal upstream analyst at Wood Mackenzie, the Edinburgh-based oil consultancy.

"Russia is offering things that have not been tackled on a large scale so far. Foreign majors can bring new technology and skills which Russian companies want to acquire."

Outside investors will ease the financial burden of inherently risky exploration ventures that take a long time to yield cash flow.

Total's relationship with Novatek looked doomed in 2005, after the Russian gas producer abruptly withdrew from a 25 per cent equity deal, choosing instead to list on the London Stock Exchange and sell stock to Gazprom.

But the French company is back in favour, as Novatek plans to diversify into LNG. After agreeing to sell Total a one-fifth share in Yamal LNG last month, Novatek said it would divide up a further 29 per cent of the project among other international oil companies.

However, analysts have warned that competition for oil and gas deals will allow Russia to demand conditions that could deter some investors.

Gazprom finally buried the hatchet with Shell last year, entering a strategic alliance with the Anglo-Dutch company to explore for oil and gas in Russia and elsewhere.

But it is also being careful to look after its foreign prospects. It warned that Russian upstream opportunities would be available only to companies willing to share oil and gas assets in other countries.



Stepping stone: Gazprom's Sakhalin II move allowed access to Asian markets