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Russia: Beyond Putin's Re-election

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In the first quarter of 2018, Russia will be in election mode. Despite the nearly guaranteed re-election of President Vladimir Putin, the Kremlin will take every measure to ensure his uncontested victory. The economy is recovering, but geopolitical theater will likely provide a better platform for the launch of his campaign. Tensions in relations with other countries will likely ebb and flow in Putin's new term in office and investors will have to adjust to this new reality of political and legal risks. In domestic economic policy, some bold and unpopular steps are likely after elections, including possible tax hikes and a crack-down on the grey labor market. Moreover, a continuing generational change is bringing more statist-minded elites to power, suggesting more red tape and increasing transaction costs.

Russia in Election Mode

On 18 March, 110 million eligible voters will elect the country's president in a direct, majority system election. While the incumbent, Vladimir Putin, dominates the polls, the Kremlin will not leave anything to chance, aiming for a convincing victory in the first round.

The date of the vote itself is a showcase of the Kremlin's trademark advance management of elections: the vote was rescheduled by a special amendment to electoral legislation to coincide with the fourth anniversary of annexation of the Crimea. This suggests that geopolitics will likely be the core of Putin's campaign messaging, distracting voters from domestic issues, especially the anemic economic growth and rampant corruption.

After two years of recession, Russia's economy returned to growth in 2017, but only just. A shallow rebound from the bottom is too little to reinstate a sense of economic prosperity in the run-up to the vote that Putin might have hoped for. Commodity prices – the main driver behind the 2014-2016 downturn besides international sanctions – have somewhat recovered and the state budget has made painful adjustment to the new, lower-price reality. However, the woes of the commodity sector did not translate into a cure for Russia's "Dutch disease."

Structural weaknesses within the Russian economy carry the main part of the blame for the fact that other sectors have failed to benefit significantly from currency depreciations and reallocation of investment. Moreover, a large part of Russian non-commodity exports is destined for markets within the Commonwealth of Independent States, which have underperformed the average emerging market growth in recent years.

While foreign direct investment (FDI) has rebounded after the collapse in 2014-2015, investors remain cautious in the face of continuing political risk. The Russian government's attempts to attract investment from China, India and Middle Eastern countries have yielded some results, but have generally fallen short of expectations. Despite EU sanctions, France has been the single largest country of origin of FDI in Russia in the past three years.

Besides the energy and infrastructure sectors, retail and manufacturing (especially automotive) have enjoyed investors' attention in recent years. The food industry and pharmaceuticals have benefited from the government's localization and imports substitution policies. However, decline of investment in communications and construction sectors dampens the picture significantly.

Overall, the economy will probably not be featured in Putin's campaign as one of his current office term successes. Moreover, continuing difficult economic situations in many regions translates into growing resentment against local and government officials that are seen as incompetent and corrupt. Anti-corruption protests that erupted in mid-2017 will likely re-flare in the run-up to the vote. To show that he acts on public grievances, Putin may dismiss some high-level government officials just before the vote. To send a strong message, a dismissal may be followed by formal charges over corruption, as it happened in the case of the former economy minister, Alexey Ulyukayev, in 2017. His own trial, which will likely run well into 2018, may be used as a televised battle against high-level corruption in the run-up to the vote.

While the demographic groups taking part in protests do not fall into Putin's core electorate, ongoing demonstrations would chip on his image. The Kremlin will ensure that an opposition candidate that could mount a credible challenge to Putin does not emerge. Russian opposition is fractured and the Kremlin will actively stoke differences among the opposition groups.

At the same time, a distraction may be presented to Putin's target voters, likely in the form of a geopolitical crisis or victory. Striking a grand bargain with the U.S., or conversely, stoking the simmering tension in one or another conflict region, would both serve the purpose, as they would both divert attention of the population away from domestic issues and offer an opportunity to present Putin as a key world leader.

Beyond Elections

After the presidential election, the tension in Russia's relations with other countries may ebb a little as the utility of the geopolitical theater will decline sharply. However, fundamental incompatibility of Russian strategic goals with U.S. and EU interests makes prospects for a real rapprochement remote.

The strategic aim for Moscow is to create and foster its own sphere of influence – mainly in its surrounding region, but also in the Middle East – and win a seat at the global decision-making table of the future multi-polar world. Immediate tactical aims include settlement of the Ukraine and Syria crises in line with Russia's objectives (not necessarily fully on Russian terms, but meeting the bottom line), and normalization of economic links.

Given the 2017 codification of economic sanctions against Russia by the U.S. Congress, it is unlikely that there would be a swift policy change in this regard. In the EU, the policy-makers may be more inclined to ease their economic measures; however, such an easing would probably be partial at best; most-likely involving some loosening of energy and financial sector sanctions. While Russian diplomats will probably make every effort to motivate easing of economic measures, the Kremlin has by now come to see them as a price to pay for pushing ahead with its strategic goals.

In Putin's new term, the Kremlin's ambitions will likely focus on increasing Russia's influence in Europe and the Middle East. Moscow may strike a deal on Ukraine or Syria in the run-up to presidential elections to provide a foreign policy victory to show off to voters. However, the complex nature of these crises suggests that any deals will be imperfect and difficult to implement, leaving space for further tension.

Moreover, Moscow will likely push further. For example, the Kremlin's well-established network of foreign language electronic media and information portals will likely continue to put forward alternative facts aiming to sow discontent among EU populations. Its army of social media trolls will probably be deployed to influence legislative and presidential elections across Europe. In the Middle East, the Kremlin will likely seek to regain the lost Soviet era influence by backing up the Syrian regime and trying to win new allies, for example, by championing one or another contender for power, as it does in Libya.

Overall, it is unlikely that Russia would return to its relatively harmonious relations with the U.S. and the EU from before its takeover of the Crimea. In the near-term, international investors should get used to operating in the new environment characterized by tense relations and punctuated by recurring crises. This means not only increased legal risks related to sanctions, but also rising transaction costs to overcome red tape or meet higher insurance premiums.

Mixed Reform Prospects

For Russia, difficult external relations will likely constrain its economic growth. The sanctions and perceptions of high political risk for external investment in Russia are the two foremost, much discussed, negative influences on the economy. Moreover, the revival of perceptions of Moscow as a strategic opponent impedes on possible future growth of Russia's exports. It has already motivated considerations of diversification of energy supplies in the EU and complicated Russia's projects aiming to improve its access to this market. While Russia's Southstream and Nordstream projects are either cancelled, or facing strong opposition, the Baltic states are planning an integrated gas market designed to displace Russian imports by LNG sourced on the world markets. Russia's Central Asian trading partners, which take in the largest share of Russia's non-commodity exports, are unlikely to make up for the lost revenue as they continue to face issues of their own and, in some cases, depend on remittances from migrant workers in Russia.

Expansion of trade relations with other emerging markets may provide an avenue for Russia. Except for China, such efforts have brought only limited fruits so far, and it remains to be seen if significant progress in this regard can be made by the next administration.

The Russian economy has well-known structural weaknesses, including, but not limited to, dependence on commodity exports. The lack of work-force mobility, an antiquated pension system, deficient corporate governance and an unhealthy financial sector are a few more to name.

In the recent past, the government has successfully reigned in troublesome government spending and stepped up its efforts to clean up the banking system. The new administration will probably introduce some unpopular fiscal policy measures to further foster the budget – the base rate of value-added tax may rise and personal income tax may increase significantly. A crack down on the grey labor market (the shadow economy, as well as misuse of self-employment contracts) is likely; however, at the moment, there are no signs that a more comprehensive labor market reform is forthcoming.

Instead, the new presidential term may allow a bold step to comprehensively address the ailing pension system. However, outlines of this difficult reform will likely be kept under wraps until the March vote, as they are unlikely to be a popular election message.

However, it remains unclear what will be the broader economic growth plan for Putin's new term in office. This is due to divergence in advice offered to Putin by his individual team members. Alexei Kudrin, who has returned to prominence as the head of the Center for Strategic Research, has presented to Putin a program of fiscal austerity. In contrast, Boris Titov, head of the Stolypin Club and Business Ombudsman, has published a full growth strategy centered around quantitative easing. It remains to be seen which one of the competing proposals will win the president's favor.

New Elites

Over the past two years, Russia has seen a gradual generational change in top administrative and regional government positions. This process will probably continue and it will slowly shift the character of Russia's regime away from a state oligarchy, towards greater dominance by security-related ministries and individuals. The result may be a more closed, controlling and confrontational Russia, and an increasingly difficult operational environment for international businesses.

The new elites are different from their predecessors in their personal backgrounds and characters. They tend to be hand-picked for their loyalty to Putin and their ability to deliver on orders. Dedication to the restoration of Russia's global power status, the new source of political legitimacy of the system after the formerly buoyant economy has started to falter, appears increasingly important. Moreover, as the earlier generation of oligarchic elites around Putin increasingly fails to deliver results, security-relevant ministries are gaining greater weight.

Yet, it would be misleading to refer to this generational change as a securitization of the political system, as power is not being simply handed to former military brass. Instead, the Kremlin champions individuals that deliver results. This shift may thus help the government to address public grievances such as corruption, flashy lifestyles and ineffectiveness of local and regional officials. Yet, public opinion appeasement will likely prove temporary. The replacement of the most ostentatious officials by new low-key, more effective ones, will likely be seen as an improvement, but these new elites are unlikely to effectively tackle the pervasive corruption.

On the central level, Putin will likely keep his mixed and somewhat cacophonic economic team in near-term. Yet, the generational change across the system will likely translate into a more pronounced statist tendency in economic policy, an increasing suspicion of foreign businesses and into efforts to ween-off imports. This will lead to greater pressure to build local production facilities in a wide variety of sectors considered to be strategic, from pharmaceuticals to telecommunications. Pressure to completely replace some imports with domestic production will likely increase. More regulation, licensing requirements and constraints on technology transfers will also be likely. The use of economic tools in foreign policy, such as sanctions, import bans or restrictions on health and safety grounds, will likely continue. Foreign businesses may thus face increased compliance and insurance costs. Finally, foreign businesses may need to seek new personal contacts as elites change.

Mid-Term Business Implications

To sum up, the Russian president's economic growth plan is unclear and elites are in flux. This means higher than usual levels of unpredictability in Russia's investment environment will persist well beyond the election and into the mid-term. In any case, statist tendencies among the new elites are on the rise and more red tape and preference for localization should be expected.

Legal and political risks will likely continue to surround trade and investment in Russia in the mid-term. It is likely that any U.S. or EU measures against Russia will be met by response in kind, be it expulsion of diplomatic staff or sanctions. Foreign investors in Russia may become a target of regulatory harassment, intrusive supervision or nuisance lawsuits in case that Moscow's relations with the country of their origin deteriorate. Iconic brands in high tech, consumer goods and food sectors are the most exposed to such policies.

Overall, investors ought to get used to the new normal in Russia; both in terms of increasing statist tendencies and troublesome international relations.

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