

August 29, 2016

## What's Putin up to?

*(Due to the Labor Day holiday, our next report will be published on September 12, 2016.)*

Over the past few months, Russian President Vladimir Putin has been unusually active on multiple fronts. He has expanded his military operations in the Middle East in support of Syrian President Assad, boosted troop strength on the Ukrainian border and conducted a major purge and restructuring of the Russian government. He has also accused Ukraine of terrorist activity in Crimea, which he seized in 2014.

In this report, we will offer a short recap of Putin's recent activities. To create context for these moves, we will discuss how these actions fit into Putin's hold on power. As always, we will conclude with potential market ramifications.

### Recent Actions

Here are some of Putin's recent actions:

***Putin is increasing tensions along the Ukraine border:*** After several months of quiet, a series of events and actions have raised concerns about the potential for Russian aggression. Putin has claimed that Ukrainian forces made an incursion into Crimea. Ukraine has denied this, and suggested that the apparent scuffle was between two Russian units that were reportedly under the influence. Putin has also increased troop strength around the region. European ceasefire observers<sup>1</sup> have

noted an increase in ceasefire violations and heavier weapons on the Russian-controlled lines, a violation of the Minsk agreement. The Russians have upgraded their air defense systems by placing the state-of-the-art S-400 anti-air missile batteries in Crimea. We note that forces in Donetsk and Luhansk, the contested areas in Ukraine, have been put on high alert.

### ***Military support for Syria has increased:***

Russian air assets have been bombing rebel positions near Aleppo in recent weeks. Surprisingly, Russia began limited air operations from Hamadan Air Base in Iran. It seems that Iran was open to giving Russia a place for air operations but felt Putin was touting it to the world to signal Russia's widening influence in the region. Iran apparently did not anticipate the publicity that would come from granting Russia permission to use the facility and it was revoked last week. After all, Iran does not want to be seen as being dominated by an outside power.

### ***There has been a rather widespread purge:***

Most recently, Sergei Ivanov, Putin's longtime chief of staff, was relieved of his duties and demoted to a staff role involving the environment and transportation. This move was something of a stunner as Ivanov was considered for the president's position when Putin traded places with Dmitry Medvedev in 2008-12<sup>2</sup>. Ivanov's demotion is part of many other changes to the government. At least 12 federal district bosses have been replaced. Several senior officials have been arrested on bribery

<sup>1</sup> With the Organization for Security and Cooperation in Europe (OSCE).

<sup>2</sup> Due to term limits, Putin became prime minister in 2008 and Medvedev became president.

charges. Putin created a National Guard, which is mostly for domestic security and personal protection for Putin. It is nominally led by Putin's former bodyguard, Viktor Zolotov, but the new security group is under direct control of the president. Putin also brought back Alexei Kudrin, a liberal economist, into government (see below).

A major reshuffle of the Federal Security Service (FSB) has been undertaken. Igor Krasnov, the investigator for the Boris Nemtsov assassination, was named as leader of the Investigations Committee, a body that investigates corruption and is under the direct control of the president. It has been called the Russian version of the "Untouchables." The longtime head of the Customs Services, Andrey Belyaninov, a close friend of Putin, was arrested by the Investigations Committee earlier this month.

These recent moves are part of a longer term pattern. In May, Putin relieved 50 senior naval officers from the Baltic Fleet, including the commander, Vice Adm. Viktor Kravchuk, and his chief of staff, Rear Adm. Sergei Popov. Last year, Vladimir Yakunin, the head of Russia's railways, was removed after a flagrant display of wealth; Yakunin had a reputation for corruption.

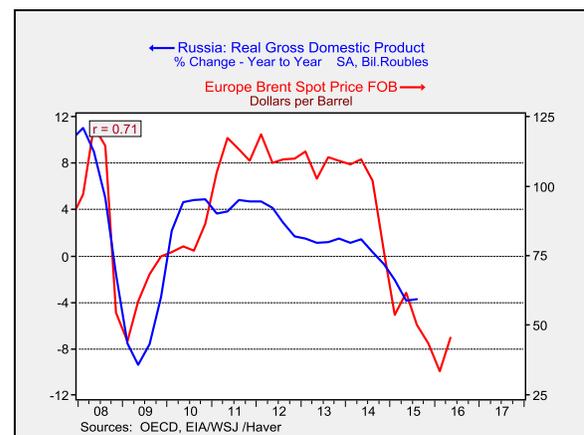
**Putin is wooing Erdogan:** Last November, a Turkish F-16 shot down a Russian Sukhoi Su-24 bomber that had strayed into Turkish airspace. Needless to say, Russia was furious over the incident and relations soured between the two states. Since then, the two countries have tried to repair relations, with Putin going out of his way to improve the situation following the recent coup attempt in Turkey. In fact, in a surprising development, Putin has indicated he would consider siding with Azerbaijan, an ally of Turkey, against Armenia, a long-

time ally of Russia, to force Armenia to give up part of the disputed region of Nagorno-Karabakh.<sup>3</sup> Even more shocking, it isn't obvious that Turkey gave up anything for this offer, although recent media reports suggest that Turkey may allow the Russian Airforce to use its base at Incirlik. This airbase, which has been used for years by U.S. and NATO forces for Middle East operations, is a key facility and allowing Russian access would be of major concern to the West.<sup>4</sup>

### Putting it into Context

Putin is often referred to as a dictator, but that assumes he has absolute power, which probably overstates his strength. He has significant constraints that he has to manage. The recent shifts are in response to these constraints:

**The Russian economy is dangerously dependent on hydrocarbons:** The Russian economy has become almost single dimensional.



<sup>3</sup> See WGR, 4/18/2016, [Nagorno-Karabakh](#).

<sup>4</sup> [http://www.stripes.com/news/turkey-open-to-russian-planes-at-us-incirlik-hub-1.425113?utm\\_source=Sailthru&utm\\_medium=email&utm\\_campaign=New%20Campaign&utm\\_term=%20ASituation%20Report](http://www.stripes.com/news/turkey-open-to-russian-planes-at-us-incirlik-hub-1.425113?utm_source=Sailthru&utm_medium=email&utm_campaign=New%20Campaign&utm_term=%20ASituation%20Report)

This chart shows the price of Brent crude oil and the yearly change in Russia's GDP. The two series are correlated at 71%. The country failed to diversify during the period of high oil prices and now must deal with weak growth during the current weakness in oil prices.

***Political power is split between the technocrats and the security officials:*** Since Putin has been in power, he has had to manage two powerful groups, the security officials and the technocrats.<sup>5</sup> The security officials were members of the Soviet intelligence or military apparatus and are usually referred to as the “siloviki,” or the strongmen. The technocrats are called the “civiliki,” or the civilians. Putin needs both groups in order to remain in power. The siloviki ensure that civil order is maintained and that the military can defend the country from outside threats. The civiliki are necessary for the economy to function well, although if oil prices are high enough, the economy can generally maintain its growth without the technocrats' influence. When oil prices were high and Russia was facing color revolutions in its near abroad, the siloviki became more powerful. They put themselves in charge of the major state-owned firms and reaped enormous wealth through corruption. Putin was willing to ignore this behavior when oil prices were strong but it has become a problem with lower oil values.

Bringing back Alexei Kudrin signals that Putin wants to put the economy on a more sustainable path. Kudrin is arguably the most highly regarded of the civiliki and will give Putin economic policies that, if executed, could reduce Russia's dependence on energy. He is also seen as incorruptible, which boosts his standing with Putin. Unfortunately, Putin cannot completely oust

the siloviki, at least not until he reduces their power. We suspect the purges of the various security services are a direct attempt to reduce the influence of the siloviki and return the civiliki to power.

Putin remains very popular but other Russian officials are not. Putin's approval ratings have been between 80% and 90% since 2013. However, the public does not care much for the rest of the government; the regional governors' approval rates have mostly hovered around 50%. Putin is seen as powerful and honest, while most Russian officials are seen as corrupt. The other goal of the purges is to replace officials in front of the Duma elections, which are being held on September 18. Since these officials are unpopular, replacing them should boost Putin and his party's (United Russia) popularity. We also note that Putin is replacing many of these officials with former presidential bodyguards and low-ranking officials. This makes these replacements beholden to Putin and increases his power over the siloviki. In fact, it is quite possible Putin fears a coup attempt from his former KGB colleagues. This purge may be part of securing his position.

***Russia must control Ukraine:*** As we have noted on numerous occasions,<sup>6</sup> Russia is virtually indefensible if Ukraine is allied against it. At a minimum, Russia needs a neutral government in Kiev. At present, it faces a government in Ukraine that leans toward the EU. Putin has two tactics to accomplish this goal. First, he wants to raise the West's costs of supporting Ukraine by making threats that suggest NATO may need to go to war over Ukraine, which is probably a non-starter outside of Eastern Europe. Second, Putin realizes that taking

<sup>5</sup> See WGR, 10/3/11, [The Return of Vlad](#).

<sup>6</sup> See WGR, 2/8/16, [Russia's Struggles](#), and WGR, 9/30/13, [Putin's Gambit](#).

control of Crimea and parts of eastern Ukraine has reduced the Russian-leaning voting bloc, leaving the remaining Ukrainian voters friendlier to the EU. Thus, Putin needs Donetsk and Luhansk to be reintegrated into Ukraine with some degree of autonomy to boost Russian influence. Although Putin needs this region to reintegrate into Ukraine to lift Russian influence, he cannot be seen as abandoning the rebels either. Thus, we view the recent troop movements as a way to improve Russia's negotiating position with the goal of gaining influence in Ukraine and, as a side benefit, boost the economy by easing Western sanctions.

***To maintain Putin's popularity, he needs to make Russia at least appear to be a global power:*** This goal is difficult because the Russian military doesn't have the ability to project power far beyond the nation's borders and the economy can't sustain a long military operation. The primary stage for enhancing Russia's global image is in the Middle East. The Obama administration appears reluctant to maintain U.S. influence, thus creating a power vacuum. Russia is trying to take advantage of this situation. Putin's about-face with Erdogan is likely part of this strategy. If he can woo Turkey away from Western influence, it would be a major foreign policy coup. We doubt Erdogan really wants Russian friendship; the Russian economy can't really help Turkey all that much. However, Erdogan may be able to use the fear of Russian influence to encourage the Obama administration to extradite Fethullah Gulen and allow Turkey to quash Kurdish nationalism.

As part of this goal to expand Russian influence, we are seeing an attempt to affect

the U.S. presidential election. It appears that Putin would rather have Donald Trump in the White House. Trump's foreign policy is Jeffersonian in nature which would reduce U.S. influence globally. On the other hand, Sen. Clinton's foreign policy is Wilsonian in nature; she will be more inclined to intervene in foreign nations and to contain Putin's ambitions.

### **Ramifications**

Although Putin's actions in Ukraine have led some commentators to worry about an impending invasion, we doubt that will be the case. After all, a belligerent Russia is more likely to ensure a Clinton White House. However, we do think the Obama administration is leaving an opening in the Middle East that Russia would love to fill, if for no other reason than to drive up the price of oil. Iran's recent decision to halt Russia's use of its airbase suggests that Iran will oppose Russian expansion in the region. On the other hand, Turkey can use Russia's friendliness to bolster its own position at the expense of Iran's influence.

It should also be noted that Putin's aggressive actions do not signal a leader who feels confident in his position. Replacing older officials with younger ones that lack credentials for the positions hints that the Russian president is starting to prize loyalty over competence. That behavior isn't unusual for authoritarian regimes, but it rarely leads to good policies. Thus, barring some event that drives oil prices higher, we suspect the Russian economy and financial assets will continue to be appropriate only for the most risk-tolerant investors.

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**Confluence Investment Management LLC**

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