Russia’s Oligarchs and Making the Loyal Economy

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Senior Honors Thesis, Tufts University, 2013

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Introduction

Capitalism came to Russia as a conqueror, replacing the decaying socialist order of the Soviet Union and transforming all of Russian business, politics, and society within a matter of years. Chaos ensued. The former superpower's economy collapsed, millions of its citizens were thrown into poverty, and Russia became the world's political and economic basket case. Crime, a virtually unknown phenomenon in the Soviet years, exploded onto Russian streets and vast swaths of the economy became the territory of the mafia and other organized crime groups. The government's erratic behavior and obvious weakness seemed embodied by the stumbling, fiery, and often drunk persona of Russia's first president, Boris Yeltsin. After hovering on the brink of collapse for the 1990s, Russia turned a corner when a new president, Vladimir Putin, came to power. The factors behind Russia's recovery are still debated, but Putin oversaw a nearly miraculous economic rebound, a crackdown on rampant criminality, and the reestablishment of government power in Russia and abroad. Putin's initial miracles gave way to more sober realizations. His government had effectively renationalized broad sectors of the economy, cracked down on dissent, and undermined Russia's already weak democratic institutions. Despite constitutional term limits, Putin has held power in Russia for the last 12 years and is positioned to do so for the next 12, making him the longest Russian ruler since Stalin.

During the years since state socialism's collapse, one group proved indispensible in the economy: the oligarchs. They were the few smart enough, well connected enough, or both to prosper in Russia's new, frightening market economy. They came from varied backgrounds and had very distinct personalities but their commonality was success—

specifically, where all others had failed. While millions lost their life savings during the 1990s, the oligarchs were consistently able to turn a profit from the chaos, quickly becoming Russia's richest men (for they were all men) and owning vast enterprises that dominated the Russian economy. They enmeshed themselves in the governance of the country, saving Yeltsin from defeat in the 1996 elections and reputedly becoming the true king-makers of Russia. Putin's ascent to power to some heralded to some a new political and economic order. He brought in comrades from the St. Petersburg city government and the security services to reassert state authority in the economy, driving out a few oligarchs and barring the remaining from any significance in either politics or the economy.

Yet this view of Putin's crusade against the Yeltsin-era tycoons obscures a more subtle, complex picture of this odd breed of businessman particular to Russia. The oligarchs established a system of relations between political and economic power that was indispensible to Putin's establishment of power. Alena Ledeneva best describes these relations in her book *How Russia Really Works*, where she employs the concept of *krugovaya poruka* (круговая порука), or joint responsibility. The oligarchs cultivated informal relations with government officials and enterprise management for their mutual financial benefit. The functioning of the network of these relations roughly follows the dynamics Ledeneva describes at work in a *krugovaya poruka* arrangement. A group bound by a joint responsibility over a business operation is held equally responsible for the actions and obligations of its individual members.[1] The oligarchs included government officials in their operations by necessity, binding the actions of political and

[1] Alena Ledeneva, *How Russia Really Works.*(Ithaca, NY: Cornell University Press, 2006), 91

business figures. Successive government actions and economic circumstances would only reinforce incentives to pursue economic and political ends jointly.

Putin used the close connection of political and economic power that he inherited to assert his own control over Russian businesses. Marshal Goldman describes the culmination of this program to secure the loyalty of Russian business and Putin's power the "National Champions" policy. Putin nationalized large sectors of Russia's most lucrative industries, particularly in energy, to harness their revenues and influence in the service of the state.[2] This policy put him at odds with some oligarchs, evident in the arrest of Mikhail Khodorkovsky in 2003. However, Putin did not fight against the oligarchs as a class, but used the persecution of some to support control over the network of joint responsibility permeating Russia's political economy. Oligarchs remained essential in Russian business after Putin's arrival, but Putin had guaranteed their loyalty through establishing power over these networks of *krugovaya poruka*. By ensuring the oligarchs' loyalty, Putin gained the loyalty of the economy. Under Putin, the oligarchs went from Russia's kingmakers to subjects of a Tsar.

A few undisputed oligarchs are particularly instructive in examining the development of Russian oligarchy and the changes Putin made to it. Boris Berezovsky, Vladimir Gusinsky, and Mikhail Khodorkovsky made their first fortunes in the later Soviet economic reforms of perestroika and were colossi of Russian business during the 1990s. However, these three are the only ones Putin chose to persecute, exiling Berezovsky and Gusinsky in 2000, imprisoning Khodorkovsky three years later, and confiscating the property of all three. Two other oligarchs, Roman Abramovich and

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[2] Marshall Goldman, *Petrostate: Putin, Power, and the New Russia.* (New York: Oxford University Press, 2008), 97

Vladimir Potanin began their fortunes under Yeltsin and occupied similarly privileged and powerful positions to their erstwhile compatriots but managed to avoid Putin's wrath. Finally, an oligarch like Oleg Deripaska became significant only after Putin had come to power and he was able to build a business empire as massive and profitable as anything created during the Yeltsin period. A study of these individuals clarifies the development of state-business relations in Russia since the Soviet Union's fall and the role of these oligarchs in Putin's Russia. The story of the oligarchs uncovers the reason why, despite over 20 years since the fall of the Soviet Union, Russia has failed to establish a functioning free market or democracy.

Capital Hunger

The early oligarchs faced a very strange business environment at the end of the Soviet Union. The last Soviet president, Mikhail Gorbachev, introduced reforms under his wider program of *perestroika* that allowed forms of small business and freed banking from complete state control in order to ameliorate the Soviet Union's rapidly worsening economy. However, informal, personal connections based in Soviet tradition were reaffirmed by *perestroika*, and facilitated the personal accumulation of wealth. The commercialization of the banking sector made success contingent on the use of these connections in the acquisition of financial capital, money, rather than through ownership and development of property. Ledeneva's concept of "joint responsibility" describes how these informal connections became semi-corrupt, unofficial business networks during late Soviet reforms. These networks were embodied in the banks and financial operations set up by the oligarchs who were laying the groundwork of business empires. The informal connections between oligarchs and government officials would define state-business relations in Russian capitalism and yet had their roots in late Soviet reforms.

The hybrid economy of state ownership and private wealth presented a confusing picture of Soviet business. Sylvia Maxfield and Ben Ross Schneider describe one definition of business as the movement of financial capital that may be helpful for interpreting business during the late 1980s and early 1990s. In their book *Business and the State*, they note that business' relationship with the state can be observed in the investment decisions of people in business. The oligarchs' survival depended on the movement of financial capital because banking was the most lucrative industry reformed during *perestroika*. The typical model of this theory that they describe holds that liquid asset holders, i.e. investors, strive for profit maximization, low taxation, strong property rights, and favorable regulations while the state aims for economic growth and benefits for certain constituencies.[3] The movement of capital can pressure the government to promote certain policies while those policies can also shape the flow of capital. Ideally, this process creates a cycle where business and the state compromise and cooperate to mutually benefit one another. Despite giving a conceptual framework to analyze Perestroika's political economy, Maxfield and Schneider's theory is still problematic for the Russian case. State-business relations in Russia from 1987-1991 did not produce a virtuous cycle of economic improvement. Even with intervening political crises, economic reform and development in Russia was staggered, incomplete, and rarely guided by ordered business-state relations. Perestroika's reforms and the oligarchs' success in business set the groundwork for interactions between the public and private sector for the next two decades. Why did Russian state-business relations develop along different lines than the model might suggest?

The answer lies in the behavior of investors and governments in Maxfield and Schneider's model versus the behavior of oligarchs and Russian officials during Perestroika. The theoretical businessmen and bureaucrats have defined interests, respective to their group, for which they will advocate in order to better the position of their group. Russia's oligarchs and officials however found a working relationship which put their individual interests ahead of loyalty to the interests of their respective group. Oligarchs, industrial bureaucrats, and state officials formed networks of mutual interest

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[3] Sylvia Maxfield and Ben Ross Schneider, *Business and the State in Developing Countries*. (Ithaca: Cornell University Press, 1997), 40

that benefitted these networks' members individually, but undermined the goals state and business as outlined by Maxfield and Schneider.

Khodorkovsky, Gusinsky, and Berezovsky did not follow the behavior predicted by the model because government policies provided little incentive to act with classical capitalist ideals in mind. The pursuit of personal profit in a system of mixed socialism and capitalism encouraged leaching capital from valuable assets and close, cooperative relations between the oligarchs and state officials. The officials in cooperation with these oligarchs had little interest in furthering government economic policy that could undermine their position arbitrating between state owned parts of the economy and the privately owned gains from it. Networks of joint responsibility formed around the oligarchs' profit-making ventures, including officials by necessity and binding Russia's first businessmen with official patrons. Legal and economic ambiguity was essential for the oligarchs and their patrons to gain money at the expense of the state. Both the economy and government of Russia were to prove the losers from the centrality of krugovaya poruka in defining relations between business and state. The state's own reforms during Perestroika ensured that krugovaya poruka was a more profitable business model than the vision of business and state offered by Maxfield and Schneider.

Freeing the Bankers

The roots of these informal networks were evident in the reform of Russia's banking industry. Perestroika's reforms had turned the centralized banking system of the Soviet Union into a confusing web of state and commercial banking operations. The first step in reform came in 1987 when the Soviet government formed five specialized banks, "spetsbanks," for agriculture, foreign trade, industry, housing, and savings, to distribute credit in their sectors rather than it being done by the central bank.[4] However, problems materialized immediately. The central bank, Gosbank, disliked the new system because it gave spetsbanks a monopoly on credit to enterprises, while bureaucrats in the spetsbanks disapproved of Gosbank control over details of their operations like interest rates. In 1988, commercial banks were set up with Gosbank support in the hopes of undermining the spetsbank monopoly but legal guidelines were not set up until the following year.[5] The commercial banks were unencumbered by Gosbank's control and could set all terms of credit on the basis of voluntary agreements with clients, accepting any kind of property or assets as collateral despite the fact that private property still lacked a legal basis.[6] The lack of clear regulation or ownership presented a lucrative opportunity to anyone daring enough to attempt navigating the mess.

Accordingly, this "hybrid" banking system between commercial banks and spetsbanks led to "distortions and abuses" as commercial banks used their position of arbitrage to exploit discrepancies between the reformed and unreformed sectors of the economy.[7] The profitability of the commercial banks activities, ranging from reselling scarce commodities to dispersing government credit, meant the end for spetsbanks. To survive, spetsbanks began moving into commercial banking, both to earn money from market distortions, but also to create "a personal airstrip for a safe landing in case the spetsbanks are eliminated."[8] A government policy to undermine spetsbank power was reinforced by Yeltsin's push to introduce capitalism and reject the Soviet power structure.

[4] Thane Gustafon,. *Capitalism Russian-Style.* (Cambridge: Cambridge University Press, 1999), 81
[5] Joel Hellman. *Breaking the Bank: Bureaucrats and the Creation of Markets in a Transitional Economy*. (Columbia University Dissertation, 1999), 138-139
[6] Ibid, 141
[7] Ibid, 187
[8] Ibid, 194

Yeltsin's government reformed the process of registering banks at the end of 1990, and hordes of spetsbankers converted their bank branches into separate, joint stock banks. Almost immediately, no spetsbanks were left in the country.[9] The same month, private enterprise was legalized in all forms of organization, giving the rudiments for capitalist experimentation during the Soviet Union's last months.[10] Reform had given the oligarchs means to profit through exploitation of an economy largely owned by the state but open to private enterprise.

Establishing Joint Responsibility

This tortured process of reform enmeshed new private enterprises in a system of state ownership. Thus, the state's support was essential in the creation of individual wealth. Mikhail Khodorkovsky was one of the few who succeeded in navigating the legal and political limbo surrounding the capitalist experiment. A deputy chief of the Soviet youth group, the Komsomol, and well regarded for his hard work, Khodorkovsky was permitted by the Komsomol to enter business. The Komsomol was losing money quickly as its membership dues declined and decided to allow Komsomol organizations to "self-finance" with the approval of Soviet and KGB officials.[11] Khodorkovsky began a café with little success but in 1986 the Soviet government allowed Komsomol members to establish "Centers for Scientific Technical Creativity of Youth," and Khodorkovsky started "The Foundation of Youth Initiative." These groups were permitted so that approved individuals, Komsomol members, could earn extra money by providing needed

[9] Ibid, 201
[10] Anders Aslund.. *How Russia Became a Market Economy*. (Washington D.C.:The Brookings Institute, 1995), 39
[11] David E. Hoffman. *The Oligarchs: Wealth and Power in the New Russia.* (Cambridge: Public Affairs, 2002), 104

technical expertise to Soviet enterprises.[12] In 1987, his superiors told Khodorkovsky that he could continue his rise through the Komsomol or continue his "self financing tricks." Nervously, Khodorkovsky chose the latter and walked out.[13]

"All the ventures that were started at this time succeeded only if they were sponsored by or had strong connections with high ranking people," Khodorkovsky remarked in 1991. [14] Desperate for "startup capital," Khodorkovsky used his Komsomol connections to gain funding from the State Committee on Science and Technology and from the well regarded Institute on High Temperatures. The director of the latter noted that he knew Khodorkovsky would never benefit his institute or return the 170,000 rubles (a very large sum at that time) the director lent him, but helped him regardless.[15] Khodorkovsky would later use his connection to these government organs as protection from police and others.[16] Shortly after founding his Youth Institute in 1987, Khodorkovsky reorganized it as a cooperative, a semi-independent business allowed at the time, and began to import computers from abroad to sell for enormous sums in Russia.[17]

Vladimir Gusinsky similarly sought out political protectors who could give him access to funds, culminating in his partnership with Moscow Mayor Yuri Luzhkov. Gusinsky had a checkered past, including stints as a taxi driver and theater director, and hated the people who held him back, often because he was Jewish. Despite his quick, often ill-timed, temper, Gusinsky made useful connections remarkably well. His brief

[12] Ibid, 105
[13] Ibid, 107
[14] Ibid, 101
[15] Ibid 108
[16] Ibid, 115
[17] Ibid, 117

career in theater gave him access to high-ranking party officials like Yuri Voronov, deputy head of the Culture Department of the Central Committee, who protected him from harassment from low-level KGB agents. Gusinsky also became close with Fillip Bobkov, a long serving deputy director who helped create the KGB's notorious Fifth Main Directorate, which combated dissidents. Bobkov later became a business associate and head of security for Gusinsky's expanding corporate empire.[18] Gusinsky's ability to make connections was essential to his rise, all the more since Gusinsky lacked the legitimacy and respect that afforded to Khodorkovsky thanks to his position and contacts through the Komsomol.

Gusinsky found financial success first in the mid 1980s, when he made 259,200 rubles selling small copper bracelets. Such bracelets were in style and Gusinsky used finesse and contacts to obtain state-owned copper wiring and use of a metal-stamping plant so that he could begin manufacturing his own bracelets, making "a gigantic profit." In 1988, Gusinsky founded Infeks, a small cooperative aimed at helping foreigners understand business in the Soviet Union and in December of that year, in joint partnership with a Western consulting firm formed the company Most.[19]

It was during this time that Gusinsky made the most important connection of his career, Yuri Luzhkov. Luzhkov would later become the hugely influential mayor of Moscow in 1992, but in the late 1980s, Luzhkov was a mid-level bureaucrat who was charged with licensing cooperatives. Gusinsky understood that for important bureaucrats, petty bribery was useless. Instead it was important to set up good relations with a bureaucrat. Better than a bribe, an opportunity to advance a bureaucrat's career could

[18] Ibid, 159
[19] Ibid

help Gusinsky manipulate the bureaucrat into helping him. "So it was always important for me to understand, what does this boss need?"[20] Although both men were still low on their respective hierarchies, Gusinsky maintained warm ties to Luzhkov, who would prove invaluable in the expansion of Gusinsky's company Most. In the early 1990s, Gusinsky used his influence with Luzhkov to draw in Moscow's municipal accounts into his Bank Most, begun as the accounting department of the Most Company but which quickly became powerful through Luzhkov's patronage. Investigative journalist Yuri Shchekochikhin wrote that he found evidence that Luzhkov was selling Moscow real estate for nothing to Most. The journalist's investigations did not damage their profitable relationship, and Gusinsky maintained his lucrative real estate business throughout the 1990s.

Like Gusinsky, Boris Berezovsky was not one of the lucky few authorized by the Soviet government to become rich during reforms, but he was determined to make useful connections regardless. He was older, in his late forties when reforms began, than the much younger Khodorkovsky. In the mid 1980s, Berezovsky seemed set firmly on a scientific career, earning the highest level of scientific qualification at the prestigious Institute of Control Sciences.[21] He was spectacularly ambitious and was determined to earn the Nobel Prize. Then came perestroika. His colleague and later business partner Leonid Boguslavsky remarked on Berezovsky that "If perestroika had not brought the commercial side, he would have been going after the Nobel Prize until he died."[22] Berezovsky directed his considerable efforts at making a fortune and in 1988 began selling software developed at the Institute of Control Sciences to the State Committee on

[20] Ibid, 160
[21] Ibid, 133
[22] Ibid, 135

Science and Technology, the same state organ that funded Khodorkovsky's early ventures. Berezovsky was determined, at any cost, to find a suitable patron within the government and during this time volunteered as a chauffeur for executives at Avtovaz, the mammoth Soviet car manufacturer. Berezovsky had worked with Avtovaz before, improving the company's efficiency and proving the utility of his research while at the Institute. He listened attentively to all that the executives said while he drove, and in January of 1989 met with former scientific associates and formed a plan to build his own joint venture with a foreign firm. [23]

In May, Berezovksy founded Logovaz, using connections made while chauffeuring. He then used his influence with one Avtovaz deputy director, Alexander Zibarev (who asked for Berezovsky's extensive help to prepare for his thesis defense), to lure top Avtovaz executives to also maintain positions at Logovaz. He incorporated these industrial bureaucrats into his new business and used their influence over Avtovaz to ensure lucrative deals with Logovaz, importing 846 Fiats for retail, all on a 5 million dollar loan from Avtovaz.[24] Berezovsky learned immediately, like Gusinsky, that offering a bureaucrat an opportunity was a more effective way to secure patrons than petty bribery.

<u>Bleeding the State</u>

Each of the three oligarchs came from different backgrounds, but nonetheless pursued similar strategies to succeed in Russia's fledgling business environment. Each was concerned with obtaining capital because without cash, none could even participate, let alone succeed, in business. The oligarchs bled the government of funds, using the

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[23] Ibid, 142
[24] Ibid, 144

partially reformed credit market to divert state credit to their own enterprises. This practice may run counter to Western business ethics, but was unavoidable in Russia. For any entrepreneur to succeed during the Soviet Union's experiment with capitalism and Russia's subsequent reform efforts, funding was essential. As the only source of capital, the Soviet state was the ultimate and necessary creditor to these budding oligarchs.

Khodorkovsky cooperated with numerous factory directors to turn government subsidies into hard cash, bleeding state funds for commission. This profitable venture at the edge of legality was only possible thanks to the tortuously confused economic order begat by perestroika. Khodorkovsky stumbled upon one hugely profitable loophole created by the government's patchwork of regulations to the credit market. Soviet enterprises were funded by two kinds of credit: cash (nalichnye) and non-cash (beznalichnye). While cash was used to pay workers, non-cash existed only as an accounting unit used on ledgers but not distributed or physically used. Enterprises would use non-cash as payment for services with other enterprises, but by the late 1980s and the reform of the credit market, enterprises were desperate for cash but had plenty of non-cash which was basically worthless.[25] It was the dream of many industrial managers to convert useless non-cash into cash, but also the nightmare for Soviet planners, who knew it could undo the system. In 1987 however, the Soviet government allowed Komsomol businesses to convert non-cash into cash, as to better finance what was still a reform experiment. Khodorkovsky seized on the opportunity, and began using his Komsomol business to convert an enterprise's non-cash into cash (usually to pay habitually late wages) while his business would take a cut.[26] By turning non-cash credits into real cash

[25] Ibid, 109
[26] Ibid, 111

money, Khodorkovsky was effectively able to create rubles from nothing, defrauding the cash-strapped state in the process.

Khodorkovsky's protection exceeded the umbrella of the Komsomol. He was excellent at making contacts and connections with important officials were essential at almost every stage. Khodorkovsky went beyond just earning rubles, and began converting his rubles into international currency by buying dollars from export based sectors, particularly in the Siberian timber industry.[27] Such a complex level of financial activity would not have been possible without protection from higher ups in the Soviet government. In 1988, Khodorkovsky cofounded Bank Menatep with the state spetzbank Zhiltsobank, despite the latter contributing no startup capital.[28] Menatep soon became an authorized commercial bank, transferring government funds to enterprises and Khodorkovsky used his connections with bureaucrats to lure more government accounts to his bank. [29] Within the year, Khodorkovsky began speaking with foreign investment banks about opportunities in Russia and setting up bank accounts abroad. State officials were instrumental in engineering Khodorkovsky's rise.

Contacts were essential for protecting and furthering any business interests, especially as chaos from Gorbachev's partial reforms ballooned. Olga Kryshtanovskaia, a well regarded Moscow sociologist, found in her studies of the Russian business elite that although two thirds of the new business class were former Soviet nomenklatura, the most successful were backed early on by state interests, even citing Khodorkovsky's Menatep.[30] Khodorkovsky's rise demonstrates that to access "startup capital," he needed

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[27] Ibid, 114
[28] Ibid, 119
[29] Ibid, 124
[30] Gustafon, 111

the patronage of officials. The extent to which such patronage was simple corruption or government policy remains unclear. Toward the end of the Soviet Union, the KGB is suspected of transferring huge amounts of Communist party money out of the country lest Yeltsin confiscate it, even cooperating with the Central Committee to choose new entrepreneurs who would allow KGB penetration of the still-forming "free market."[31] Without such support and protection, the tangled mass of bureaucracy and unreformed law would have crushed Khodorkovsky's aspirations. Whether it was computer imports, credit distribution, or hard currency conversion, Khodorkovsky violated old Soviet law and tradition and "the state closed its eyes to this."[32] Since the only source of capital was the state, Khodorkovsky needed patrons to ensure no one would halt his business as he funneled state money to his business interests and profited from of the government's conflicting legal code.

By opening select sectors to private enterprise, especially within banking, the government fostered cooperation between early oligarchs and government officials. These officials supported the oligarchs in exploiting the discrepancies between the reformed and unreformed sectors of the economy. The typical model of capital as a source of state-business compromise was not applicable because government reforms encouraged official disloyalty and corporate leeching. Joint responsibility bound officials and oligarchs by their money making ventures, especially in banking. At the birth of the Russian Federation in August of 1991, the oligarchs were best positioned to succeed, having already established useful political contacts and accumulated start-up capital.

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[31] Paul Klebnikov. *Godfather of the Kremlin: Boris Berezovsky and the Looting of Russia. (*New York: Harcourt Inc., 2000), 59.
[32] Hoffman, 113

Their success and profit would only further their cooperation with government officials as they came to dominate the economy.

Vouchers and Violence

Voucher privatization brought the majority of Russia's businesses under ostensibly "private" ownership, but it also perpetuated the dynamics of *krugovaya poruka*. Accumulation of financial capital through connections among oligarchs, enterprise management, and the state remained necessary because the "red directors," former Soviet-era managers, hijacked reforms. They kept control over the assets they managed during the Soviet Union and opposed the necessary corporate restructuring intended by privatization. They preserved their enterprises' reliance on the state and informal connections for profit. Privatization through vouchers formalized incentives for joint responsibility arrangements and opened much more of the economy to the influence of business collectives. Reforms also presented new opportunities and the oligarchs adapted to the new terms of Russian business so to find new sources of revenue though different oligarchs followed different strategies for success. However, the nature of joint responsibility relations encouraged competition over political and economic interests, encouraging violence and crime in Russian society. The results of voucher privatization contradicted its primary purpose of establishing rational capitalist management in Russia's business enterprises. The plan's extensiveness ensured that the consequences of this failure were to be drastic.

Economic reforms spearheaded by Deputy Prime Minister Anatoly Chubais in 1992 destroyed Russia's system of state ownership inherited from the Soviet Union. It culminated in mass privatization of the majority of Russian enterprises through voucher distribution, approved on November 30th, 1992 by the Duma. Vouchers represented shares in the state owned firms and all Russian citizens were given vouchers with which they became new, private owners of corporate shares. Seventy seven percent of state property was targeted for voucher privatization and within a year 11,000 large scale firms had been converted to joint stock companies.[33] Citizens and workers would gain shares in enterprises targeted for voucher privatization, reducing or eliminating government involvement in those enterprises while giving citizens and workers a stake in the success of these formerly state companies. As Yeltsin summarized "We don't need a few millionaires, we need millions of owners." [34]

The Red Menace

However, voucher privatization resulted in a large-scale takeover of Russian industry by their former Soviet managers, the "red directors." These industrial bureaucrats used their power as managers and connections to the government to ensure effective control, if not explicit ownership, of most enterprises privatized during Chubais' voucher privatization. While the red directors gained control over extensive industrial assets, the oligarchs used this reform period to secure their flow of cash and enhance their political connections. Attempts at securing greater funds and assets were of mixed success; the oligarchs were trying to adapt to the new Russia and were often as unprepared for changing events as the government or Russian citizens. As economic and political struggle became deeply enmeshed, oligarchs, government officials, and mafiosi became involved in often violent struggles for political power and enterprise ownership. Chubais

[33] Lynn D. Nelson and Irina Y. Kuzes. "Evaluating the Russian Voucher Privatization Program," *Comparative Economic Studies*. Spring 1994, 55
[34] Appel, Hilary. "Voucher Privatization in Russia: Structural Consequences and Mass Response in the Second Period of Reform" *Europe-Asia Studies*, December 1997, 1435

once when asked what he had accomplished, replied “I have privatized power .” [35] The oligarchs hoped to acquire as much of it as they could.

Voucher privatization was not unique to the post-Soviet economic landscape, but Russia’s program differed from other nations’ significantly. Many post-Soviet states used privatization because it translated the state ownership of Soviet socialism into public ownership through use of enterprise shares. Unlike countries such as the Czech Republic and Lithuania, Russian reformers permitted the sale or purchase of vouchers, arguing that their citizens were intelligent enough to do as they pleased with their shares.[36] Despite the obvious flaws, many internationally assured that voucher privatization was “one of most successful privatization programs in Central and Eastern Europe and the Former Soviet Union.”[37]

Hillary Appel argues in her paper “Voucher Privatization in Russia: Structural Consequences and Mass Response in the Second Period of Reform” that it was this voucher transferability and existing dynamics between enterprise workers and management which doomed the privatization program. The Russian government had embarked on voucher privatization because simply selling the enterprises would result in an “immediate and blatant concentration of ownership among the mafia, the former *nomenklatura,* and the industrial elite.”[38] However, the result of voucher privatization was not widely distributed ownership as Yeltsin’s team had hoped but the very

[35] Hoffman, 208
[36] Hilary Appel. “Voucher Privatization in Russia: Structural Consequences and Mass Response in the Second Period of Reform.” *Europe-Asia Studies*, December 1997. 1435
[37] Ira W. Lieberman and Rogi Veimetra “The Rush for State Shares in the “Klondyke” of Wild East Capitalism: Loans-for-Shares Transactions in Russia,” *The George Washington Journal of International Law and Economics*, March 28-29th, 1996, 737
[38] Appel, 1433

concentration of ownership they wanted to avoid. Red directors had greater cohesion and influence than workers' groups or civil society advocates, and shaped privatization legislation to their advantage using lobbying groups such as the Russian Union of Industrialists and Entrepreneurs and its political affiliate Civic Union. The Russian government hoped that by giving workers at different enterprises greater ownership and allowing outside (foreign or non-managerial) actors to obtain greater control, this managerial class would be balanced out and necessary restructuring would be pursued. However, the red directors pressed further, eking out a concession whereby although managers could not purchase more than 5% of their industry (workers were allowed to purchase up to 35%), workers' collectives would be permitted to buy a majority stake.[39]

Thanks to the paternalistic relationship between managers and workers, managers easily controlled or coerced workers into keeping their shares, selling them to management, or giving up any real ownership of the shares. Organizations with especially strong management also got increased government concessions, allowing their management and corporate structure to remain unchanged; a prime example being Gazprom, where the government conceded to managers the right to approve or reject any worker attempts to sell their shares.[40] The enterprises that privatization had sought to reform remained under the same leadership and preserved red directors' Soviet style of management.

[39] Michael McFaul. "Institutional Change, and the Politics of Privatization in Russia." *World Politics*, January 1995, page 231.
[40] Appel, 1435

Michael McFaul argues that by the summer of 1993, insider managers had majority shares in two-thirds of privatized firms and very little of the structural reform, improved corporate governance, or investment hoped for by the government materialized.[41] These directors were concerned with maintaining their own positions within their enterprises to preserve the benefits and income, dubbed "rents" in the political science literature, but were uninterested in developing their enterprises to meet capitalist standards.

<u>Strategies for Success</u>

Oligarchs used the newly privatized enterprises to expand their own holdings and wealth. While these oligarchs were dependent on connections to government officials, they sought to expand their own influence as the economy was turned into a functioning market, albeit quite imperfectly. The acquisition of property promised greater influence and independence than reliance on joint-responsibility networks which dispersed economic benefit and restrained individual ambition. However, the chaos of reforms made such acquisition difficult, and so some oligarchs chose instead to expand the reach of their informal networks, raking in more money for all involved. Both strategies would ultimately reinforce the informal underpinnings of Russia's political economy.

Mikhail Khodorkovsky leapt at the chance offered by reforms to buy vouchers, recognizing that privatization was a fire sale of Russian industry. Although vouchers were initially offered at 10,000 rubles ($7) a piece, the vouchers were being traded on the street for even less. The whole voucher privatization process in the end valued all of Russian industry at around a ludicrously low $12 billion, making the entire Russian

[41] McFaul, 210

economy about as valuable as the cereal company Kellogg.[42] Khodorkovsky's Menatep bank began buying extensively in vouchers, but like everyone else operating in the vouchers market, did so almost blindly. Even basic information about companies being privatized, such as production and value of assets, was hard to find and Menatep ended up buying a patchwork of industries. Khodorkovsky called the buying spree youthful "idealism" born from his childhood wish to be a factory director. Although his motivation might have been idealism, the result was a conglomerate of industries that a Western financial consulting firm told Khodorkovsky resembled a South Korean *chaebol*. With some trepidation, Khodorkovsky decided he needed to focus his investment in one sector and decided to go into the oil industry. Bureaucrats' thorough penetration of privatized enterprises would not make this easy.[43]

Boris Berezovsky's financial designs were more successful in the chaotic but potentially lucrative mess Chubais' had dumped on the country than Khodorkovsky's buying spree. The expansion of bureaucrats' power also increased the value of corruption to oligarchs in their struggle to gain assets and funds. Berezovsky used Chubais' reforms to solidify his control over the cash flow of Avtovaz. Just as Gusinsky had found a patron in Luzhkov, Berezovsky searched for access to the power and profit offered by state support. He found such an opportunity when he was chosen to publish Yeltsin's book "Notes of a President." Although the book produced few royalties, Berezovsky set up an account for Yeltsin to which he began adding money, eventually totaling $3 million.

[42] Hoffman, 205
[43] Ibid

Berezovsky's ambitious sycophancy paid off and Yeltsin invited the oligarch to join his elite tennis club.[44]

Using the clout presidential support afforded him, Berezovsky established the venture Avva in October of 1993 as a joint venture among Logovaz, Avtovaz, and Forus, a Berezovsky owned, Swiss-based trading company.[45] Yeltsin announced extensive tax breaks for what was to be a joint venture between Avtovaz and General Motors to build a huge new factory which would manufacture a new Russian "people's car," to do for Russia what the Volkswagen Beetle had done for post-war Germany.[46] Despite high hopes, Avva was to be an epic financial scam , even by Russian standards.

Berezovksy understood that Chubais' voucher privatization had begun a rudimentary securities market in Russia and used the model of vouchers for selling Avva securities. Avva offered a huge source of funding for Berezovsky. In addition to a $150 million loan given by Banque Nationale de Paris, Avva sold $50 million in securities to the Russian public. Avva certificates sold for 10,000 rubles ($7, not incidentally the same price as vouchers) and by 1994 were trading alongside vouchers at Russian exchanges and being sold by vendors on the street. [47] Despite being denied concrete ownership of industry, Berezovsky was still able to use his connections to Avtovaz management to gain control of a revenue stream.

Berezovsky learned from the red directors' manipulation of vouchers and structured Avva's sale of securities accordingly. Berezovsky did not need legal control over Avtovaz to have effective control over its profits. The certificates Berezovksy sold were

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[44] Klebnikov 118-119
[45], Vladimir Yegorov "Russians are promised 'the people's car,'" [Россиянам обещают "народный автомобиль"]. Krasnaia Zvezda ,October, 1993.
[46] Klebnikov, 140
[47] Ibid, 141

in fact not shares of stock, but bearer certificates, entitling the person holding a certificate to exchange it for a genuine share of Avva. Trading in the certificates for shares was difficult, and Berezovksy promised to give away Avtovaz cars in a lottery for those who held the certificates in order to discourage anyone from trading them in for real shares. The lottery was held only three times, failing to distribute the promised 100,000 cars but it succeeded in getting many Russians to store their Avva certificates in sock drawers rather than exchange them while those that did have shares never received dividends.[48] Finally, Avva certificates were not imprinted with the name of the bearer, as was legally required for shares of stock. This omission served two purposes: the certificates could be traded on the street like vouchers and, lacking a definite list of shareholders, Avva could avoid paying dividends.[49] Berezovsky had raised $200 million, without any of the danger selling real equity in Avva would have posed and all with the blessing of Yeltsin's government and Avtovaz' managers.

While the Avva venture collapsed in 1994 when GM pulled its support from the project (alarmed at the endemic corruption and crime at Avtovaz), the money gained through Avva was put to use nonetheless. Berezovksy used the funds to buy a 34% stake in Avtovaz , along with another 19% which went to the company AFK, a Berezovsky creation which was in theory owned by Avtovaz but in fact was controlled by Berezovsky and Avtovaz managers. Even with this expansion of Berezovsky's ownership, there still remained $50 million with which Berezovsky paid late salaries and other costs.[50] Berezovsky had used the nascent securities market and the model of voucher

[48] "Will Avva return shares to depositors?"(Вернет ли "AVVA" долги вкладчикам?) *Argumenty i fakty*, May 6th, 1998
[49] Hoffman, 216
[50] Klebnikov, 143

privatization to raise capital that he invested in taking control of Avtovaz. The result of Avva mirrored the result of voucher privatization. Avva allowed Avtovaz management to retain control of Avtovaz while cloaking the process in the legitimacy of capitalism and economic reform. Berezovsky masterminded Avtovaz' insider takeover and he benefited by gaining effective control of the company, in league with its managers.

By taking control of Avtovaz, Berezovsky had established a dominant position in one of the most criminalized sectors of the economy. In the Soviet Union, spare parts for cars were an in-demand product on the black market. Mafiosi and gangs rushed into the auto market, establishing control over the distribution of Avtovaz cars. Mafia-linked car dealers would purchase cars at a heavy discount, at Avtovaz's loss, and then sell the cars for up to 100% profit. Each of these criminal car distribution networks became linked to different managers with Avtovaz as their source of discount cars in exchange for the proper kickbacks. Avtovaz distributors were still state owned into the 1990s and therefore had to sell their cars at a state-set price while commercial distributors were allowed to sell Avtovaz cars at market rates. Avtovaz managers had an incentive to sell their cars to commercial dealers who would pay the managers a share of profits, all draining Avtovaz of funds and effectively financing the development of an alternative, criminalized dealership network.[51]

To maintain control over Avtovaz's revenue stream Berezovsky had to maintain an extensive, and flexible system of bribery for the network of managers and criminals controlling Avtovaz's operations and auto distribution. Their continued cooperation facilitated his control over Avtovaz, and more importantly, its revenue stream. Financed by Avtovaz, Berezovsky established the company Forus on February 19th, 1992 in

[51] Ibid, 92-93

Switzerland. The ownership structure of the new firm was intentionally complex, including multiple shell companies based in numerous tax havens across Europe. Berezovsky's connections with the Yeltsin administration likely obscured his ownership of the firm further, as the General Prosecutor's office expressed no interest in Forus' owners despite later reports of irregularities. It was not until a separate investigation in 1999 that Forus' ownership was made public.[52] Although ostensibly created to make Avtovaz's finances more efficient, Forus was the site of a kickback scheme for those within the Avtovaz network. It became the basis for other Berezovsky creations, such as AFK (which used funds from Avva to aid Berezovsky's takeover of Avtovaz) and Obyedinenie Bank. The latter would hold the money of Avtovaz and the airline Aeroflot, a later Berezovsky conquest, by the end of 1995.[53] Berezovsky used Forus and its offshore corporate cousins to extract money from Avtovaz without scrutiny and use to funds to pay off managers and distributors. Although "joint responsibility" arrangements were informal, they required formal mechanisms to maintain their operations.

Mass privatization continued a reliance on these informal connections in the function of the Russian economy, and relations between government officials and oligarchs represented the most lucrative form of these connections. Clifford Gaddy and Barry Ikes argues that these connections represented "relational capital," a means of distributing value according to group membership and not individual traits that they trace to the Soviet system of "blat," or informal connections between managers to cope with the constant shortages and central planning of the Soviet economy.[54] They argue formal mass

[52] Leonid Berres,. "'The Stork on the roof' sheltered investigator Volkov" ("Аист на крыше" приютил следователя Волкова), Kommersant Daily, September 9th, 1999.
[53] Klebnikov, 89
[54] Gaddy and Ikes, 58

privatization during the voucher program came after the “spontaneous” privatization of relational capital that then became “pivotal to the operation of the economic system.” [55] The system of mutually profitable relations with government officials such as pursuing government contracts, tax offsets, and starting hard currency operations offshore should be viewed then as investments in this relational capital. They mark relational capital as a special form of rent seeking which aims to control the right to “appropriate inputs and dispose of (“sell”) outputs.”[56] While this argument purports to explain how the relationship between business and government remained so close even after the end of state ownership, the concept of relational capital is as vague as its “spontaneous” privatization.

Ledeneva’s account of *krugovaya poruka* offers a more organic interpretation, drawing as well from the Soviet concept of “blat” which developed in response to persistent, systemic shortage.[57] *Krugovaya poruka* persisted after the Soviet collapse because of the continued tenure of former nomenklatura in private business management. A Soviet-era shortage of goods had been replaced by a Russian shortage of cash, and the red directors kept using Soviet strategies to address a capitalist problem. The red directors ensured the continued importance of *krugovaya poruka* to unite figures in Russian business and government. One characteristic of these relationships was that individuals were always part of a bigger system of “svoi ludi (свои люди),” or “one’s own people.” Individuals are encouraged to seek protection and repay favors to others in the group.[58] Rather than spontaneously appearing in Russian capitalism, networks of *krugovaya*

[55] Ibid, 59
[56] Gaddy and Ikes, 121
[57] Ledeneva, 91
[58] Ibid, 113

poruka persisted through the collapse of the Soviet Union because neither the personnel nor practices of Russian business had changed since the Soviet Union. The oligarch's continued success would depend on the financial-political groups they were a part of.

Mutual Instability

These networks of joint responsibility were inherently unstable and encouraged rivalry between different financial-political networks. Such instability, born from the internal dynamics of joint responsibility arrangements, is evident in the differing strategies of Berezovsky and Khodorkovsky in response to privatization. Khodokovsky hoped to expand his ownership of property rather than his control over just the movement of financial capital because ownership promised a more stable source of income, free from dependence on well-connected bureaucrats. Berezovsky embraced connections with Avtovaz management as the sole means of profit because he could use these connections to take increasingly personal control over Avtovaz's finances. Ledeneva notes that reliance on a network of individuals for personal benefit leaves these individuals feeling mutually dependent and vulnerable.[59] Khodorkovsky's accumulation of shares and Berezovsky's accumulation of wealth were means to gaining greater self-reliance and therefore greater power in dealings with their network of officials and corporate management. The oligarchs were constantly trying to expand their personal influence within their networks by expanding the influence and profitability of the networks themselves. Since these networks included government officials, law enforcement, Mafiosi, and others, violence spread quickly during the early 1990s as a natural consequence of business.

[59] Ibid, 114

Berezovsky's close connection to the mafia for instance was not without incident. On June 7th, 1994 a bomb exploded near Berezovsky's Mercedes-600, decapitating his driver but leaving Berezovsky miraculously alive. The perpetrator was likely related to the mafia, but the motivation was unclear, experts at the FSK noted, because had the attackers wanted to kill Berezovsky personally, they would likely have used a sniper gun. Most officials suspected in was in connection to struggles for Avtovaz's car distribution network.[60]

Vladimir Gusinsky pioneered the use of a personal security force to defend against the rising tide of violence. While many entrepreneurs bought protection, called a roof (krysha), from criminal groups, Gusinsky chose to employ over 1,000 for security including many veterans from the KGB and armed forces.[61] On December 2nd, 1994 however, Gusinsky's guards and drivers were held at gunpoint, face down in the snow outside of Moscow city hall (also the headquarters of Gusinsky's Most Bank). Gusinsky, panic stricken in his office, called contacts in the local FSK (one of the KGB's successor organizations), who sent officers to the scene only to find out that Gusinsky's heavily armed assailants were members of Yeltsin's personal guard . After two hours, Gusinsky's men were released, and the armed guards sped off. Within an hour of their departure, the FSK agent Gusinsky had contacted was dismissed by presidential decree.[62] Yeltsin's chief of security Aleksandr Korzhakov had ostensibly ordered the raid to

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[60] Arkady Zheludkov, and Sergei Leskov. "Explosions around Logovaz, New Version" (ВЗРЫВЫ ВОКРУГ «ЛОГОВАЗА»: НОВЫЕ ВЕРСИИ) Izvestia.
[61] David Remnick. "The Tycoon and the Kremlin" *The New Yorker.* February 20th, 1995. 118
[62] Ibid, 122

investigate Gusinsky's participation in the collapse of the ruble in October of 1994.[63] Gusinsky's krysha was still no protection against the Russian government.

The entire incident revealed the deep struggle within Russian government for power during economic upheaval and a political transition. Korzhakov was known to despise Gusinsky personally, but was also a fierce defender of Yeltsin. Yeltsin's team worried about the 1996 election as their leader's popularity rating plummeted over the course of economic reforms. Yuri Luzhkov was seen as a potentially dangerous opponent, and the raid was an attack on Luzhkov's loyal oligarch and his company, Most. The attack Korzhakov ordered was a show of strength from Yeltsin to Luzhkov, to remind him that Yeltsin was Luzhkov's superior.[64] At this point, Berezovsky and Gusinksy had also developed a bitter rivalry, and the shared interest of Berezovsky's and Yeltsin's is striking. The journalists Natalia Zhelnorova and Andrey Uglanov wrote shortly after the attack that some within Yeltsin's circle worried about Gusinsky's growing influence within the Moscow government and increasingly the presidential administration. Compromising documents were given to Korzhakov that criminally implicated Gusinsky, giving pretext for the attack on him[65] Both oligarchs had cultivated sparring political patrons, reinforcing the link between political and economic competition. Gusinksy remarked about the December 2nd raid "there are easier ways of sending a message. This was a demonstration that a time of unlimited lawlessness is coming."[66] Gusinsky believed that the oligarch's interest in politics was natural given the chaos Russia was descending into: "There is an unequivocal understanding that the only

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[63] Ibid, 124
[64] Ibid
[65] Zhelnorova, Natalia and Andrey Uglanov. "Most Group: Freezing Again" (ГРУППА "МОСТ": СНОВА ЗАМОРОЗКИ) Argumenty i fakty, December 7th, 1994.
[66] Remnick, 134

way you can defend yourself against the lawlessness is an investment in politics."[67] After the raid, Gusinsky left with his family for London, to spend time out of the country for a few months.[68]

The dynamics of *krugovaya poruka* had produced a mutation of the political and economic competition desired by classical capitalist theory. Businessmen competed for profit and politicians for influence but they did so in union with one another. Their actions produced mutual benefit for their allies, but also mutual recriminations. As networks of mutual political and economic interest competed for influence, personal connections were reinforced as the only way of doing business. The oligarchs remained dependent on these connections and government sponsors for success. The failure of voucher privatization encouraged this route to success and laid the groundwork for a system defined by insider ownership, questionable profit, and capricious obedience to capitalist rationale.

[67] Ibid, 133
[68] Ibid, 128

The Oligarchs' Alliance

Economic policy and political necessity aligned in the notorious "Loans for Shares" auctions. These privatization auctions were the first major opportunity for the oligarchs to gain greater independence through ownership of property but the deal reinforced reliance on informal, extra-legal connections as a means to success. In Loans for Shares, Yeltsin's government handed over controlling shares of major industrial enterprises to the oligarchs in exchange for their political support in the 1996 presidential elections. The deal reflected the financial and political desperation of Yeltsin's government which was beset by debt, a stalling reform program, and an almost certain communist victory in the elections. Loans for Shares produced many concerns over their equity or public benefit, but many analysts missed the motives of joint political and economic benefit for Yeltsin's government, the oligarchs. The oligarchs' new industrial ownership ensured greater self-reliance and political support for Yeltsin. Their means of obtaining these companies however demonstrated the continued value of political influence and preserved competition between networks of business interest.

"Loans for Shares" was the perfect convergence of the oligarch's and Yeltsin's interest, involving the circumvention of fair democratic and market rules during a particularly decisive moment in Russian politics. 1995 found banker Mikhail Khodorkovsky at a crossroads. The lucrative practice of ruble-dollar speculation was finally curtailed that summer by new government regulations, eliminating an important revenue stream for Menatep. Khodorkovsky was also deliberating on what kind of company he wanted to own and manage, appalled at the idea of running the patchwork conglomerate of companies he bought during voucher privatization. Menatep had to be the kernel of his business empire by virtue of its resources, but Khodorkovsky needed to find a lucrative industry if he was to support his ambitions financially. Forunately, he was given an opportunity to make up lost revenue the same year when Yeltsin's cash-strapped geovernment began issuing new bonds, called GKOs, with absurdly high interest rates, sometimes over 200%.[69] Although GKOs would wreak havoc on government finances and the Russian economy in a few years, in 1995 they were just another means of generating money for the oligarchs. Soon, however, Khodorkovsky would get access to the assets and funds he needed to build his empire by grace of another oligarch: Vladimir Potanin.

Vladimir Potanin had been blessed with financial success after the Soviet Union's collapse. In Russia, such consistent "luck" meant powerful connections. He had worked in the Trade Ministry in the Soviet Union, selling fertilizer abroad, in a profession David Hoffman depressingly describes as a "Soviet phosphate fertilizer salesman-bureaucrat." This position however allowed him to make extensive contacts within important ministries overseeing heavy industry and resource extraction. In 1990, Potanin created Interros, a trading company which benefited handsomely two years later when a Soviet state-run bank was on the brink of collapse and a mysterious letter circulated encouraging Russian depositors in the bank to transfer their money to Potanin's bank. Within 6 months, Potanin's bank had deposits of around $300 million, compared with the years older Menatep which had $835 million.[70] In April of 1993, Potanin created the United Import and Export Bank, or Uneximbank. Uneximbank became the bank of choice for the Finance Ministry, tax service, arms export agency, and

[69] Hoffman, 298
[70] Ibid, 304-305

the City of Moscow. In 1994, Potanin's Uneximbank began the year with $322 million and ended it with $2.1 billion.[71]

By the start of 1995, Potanin had developed a plan with two American stock brokers that would include Khodorkovsky and another banker, Alexander Smolensky. The plan which came to be called "loans for shares," was straightforward: a consortium of banks, mostly owned by the oligarchs, would loan the government much needed cash, and the government would put up shares in 12 large, state owned corporations (mostly in the energy or resource extraction industry) as collateral. If the government did not pay the loan back by September of 1996, the banks would auction off their shares, keeping 30% of the profits.[72] However, Potanin had different intentions than his American consultants, who looked at the deal as a huge commission. Potanin saw the deal as a windfall. Some of Russia's most valuable companies were being privatized, giving Potanin's Uneximbank, Khodorkovsky's Menatep and three other banks (Incombank, Imperial and Stolichny) an opportunity to expand their assets considerably beyond banking into the industrial sector.[73] Potanin lobbied to exclude foreign investors from these auctions because the Russian bankers did not have the capital to compete with foreign firms in a bidding war for a broad swath of Russia's industrial base.[74] Potanin was designing a coup for Russian oligarchs that would thrust prized industrial assets into their hands for the first time.

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[71] Ibid, 306
[72]Daniel Treisman. "'Loans for Shares' Revisited" P*ost Soviet Affairs,* July-September 2010, 220
[73] Lieberman and Veimetra, 743
[74] Hoffman, 308

What is to be done?

The deal was attractive to Yeltsin's government because of his dire political predicament. Yeltsin's unpopularity threatened his tenure as President and jeopardized the oligarch's businesses if the Communists came to power. The ownership awarded to oligarchs supportive of Yeltsin's reelection was both reward and incentive. The government's offering of shares in major industrial firms guaranteed initial financing for the cash strapped Russian state, but the shares more importantly gave further interest for the oligarchs to support Yeltsin in order to safeguard their industrial gains. Thus, loans for shares reflected political and financial genius but was also an act of desperation. Yeltsin was facing the 1996 election and his Communist opponent, Gennady Zyugonov, had a strong lead. Yeltsin's government was terrified that his loss would mean a reversal of reforms while the oligarchs feared that a Communist government would confiscate their property and the oligarchs would, in the words of George Soros to Berezovsky, "swing from the lampposts." [75] As Chubais said in an interview with David Hoffman, "The fact that these would be the forces supporting their own private property, that they would defend their private property, that they would defend their private property, and that in the political process they would be, by definition, against Communists and pro-reform-that was 100% sure, and that is what happened."[76]

The oligarch's deep pockets and influence through media holdings made them invaluable resources to Yeltsin's campaign. Privatization had stalled, impeding Yeltsin's reform agenda and the oligarch's ability to gain greater self-reliance within an economy

[75]Andrei Shleifer and Daniel Treisman. "A Normal Country," *Harvard Institute of Economic Research*, Discussion Paper No. 2019, October 23rd, 2003. 6-7
[76] Hoffman, 312

dominated by networks of political and economic connections. Selling state properties to the oligarchs essentially involved using the informal connections between political and economic power to circumvent legal competition democratically or for the industrial firms offered at market. Berezovsky and Gusinsky had obtained the only two private, national TV channels- NTV was founded by Gusinsky in 1993 and Berezovsky acquired ORT from the state in 1994. These media outlets offered unrivaled influence during an election and combined with the oligarchs' direct funding and support, Yeltsin's government saw the value of an alliance. The interest of Yeltsin's government and the oligarchs was better achieved through informal mechanisms of private connections than fair play, especially when the stakes for both parties were so high.

Ensuring the loyalty of banks that would influence the outcome of the election did not exclude trying to earn as much money from the deal as possible. The government changed Potanin's original plan to ensure that the owners of auctioned shares would inherit the debt of the company as well, in an attempt to regain money lost to the oligarch's tax-evading accounts abroad.[77] However, the government's position was relatively weak, since it needed the political influence which wealthier foreign banks could not provide. Khodorkovsky himself was representing the interests of other groups who loaned him money to buy Yukos including Gusinsky's Most, a few defense factories, and most interesting the Russian government itself which was Menatep's largest depositor.[78] Yeltsin's government had forgone greater financial gain for the Russian government and improvement for the Russian economy in favor of ensuring Yeltsin's survival in the elections and the progress of his government's limited reforms.

[77] Lieberman and Viemetra, 748
[78] Hoffman 316

In exchange for loyalty however, the government was giving deep concessions to the bankers, allowing them to act as guarantor, auctioneer, and bidder for the shares put up as collateral. Evidence of corruption and unfair play abounded. Death threats, unexplained disappearances, auctions held in remote Siberian cities, and selective use of red tape ensured that competition for the shares each bank auctioned off was nonexistent. It became immediately clear to the Russian public and foreign observers that the whole process was rigged.[79] The oligarchs' banks had no intention of selling the collateral companies, just as Yeltsin's government never had thought to pay back their loan. Instead, loans for shares was an opportunity for the oligarchs to gain full control over their first meaningful property. The governments "covert" use of the oligarchs' resources to get Yeltsin was the equal and opposite reaction of the oligarchs' "misuse" of the collateral shares given to them.

<u>Auctions with No Bidders</u>

Informal connections formed the basis of the loans for share deal, necessitating the kind of legal maneuvering that made Western observers balk. Ira Lieberman and Rogi Viemetra, in their paper "The Rush for State Shares in the "Klondyke" of Wild East Capitalism: Loans-for-Shares Transactions in Russia," argue that loans for shares was a corrupt insider deal which perverted attempts to create legitimate, capitalist competition. They hold that loans for shares discredited privatization and lost revenue while stalling further efforts at privatization by infuriating the Duma and maintaining government control through insider banks. "It is hard to understand, for example, why a country striving for financial stabilization, accepted loans from *national* commercial banks in

[79] Klebnikov, 205

strictly *foreign* currency."[80] Moreover, it was a "lose-lose proposition" for all stakeholders in Russia. They expressed concern at the concentration of ownership it resulted in and the ability of the banks to manage their financial-industrial groups.[81]

Indeed, corruption was obvious during the auctioning of loans for shares properties. Khodorkovsky claimed Yukos by establishing two proxy companies to "compete" at auction for the shares Menatep held. As part of regulations for the auctions, bidding companies had to submit balance sheets to the government in advance and if they did not, the shares of the company could be bought by the guarantor bank, in this case Menatep. Khodorkovsky's front companies failed to submit the paperwork, and Menatep acquired Yukos, avoiding a competitive auction entirely.[82]

The acquisition of Yukos reflected the primacy of political over financial needs for Yeltsin's government. Outsider banks, originally not included in Potanin and Khodorkovsky's consortium, lobbied the government saying that the auction was unfair and that they would offer a higher price for Yukos, but with a caveat: they would pay $370.2 million in a combination of cash and the government's new bonds, GKOs.[83] The government rejected their offer, reflecting the government's own insecurity that it would not even accept its own bonds. The group went public with its accusations at Menatep, saying the government needed to correct a privatization program which was "insufficiently thought-out, and of often dubious organization of the present stage of

[80] Lieberman and Viemetra, 757-758
[81] Ibid, 759
[82] Ibid, 754
[83] Hoffman, 316

privatization leads to irreparable losses for the Russian economy."[84] Indeed, with the exclusion of outsiders, it was apparent that the loans-for-shares endeavor was not primarily designed to raise funds for the government. The Russian government became a stakeholder in Menatep in February of 1995, giving Menatep 60 billion rubles auspiciously before it was to give that same money back to the government in exchange for valuable property.[85]

Berezovsky's acquisitions during loans for shares also reflected the blatant inequities decried by Lieberman and Viemetra. Partnered with loans-for-shares co-creator Smolensky, Berezovsky obtained Sibneft, an oil company created on August 29th, 1995 by Presidential decree which was formed from the former assets of the Ministry of Energy and Rosneft. The two used their extensive government connections to make the Sibneft auction every bit as farcical as that of Yukos. The auction was held by a Berezovsky subsidiary (FNK or Financial Oil Company) while the buyer was yet another Berezovsky creation (NFK or Oil Financial Company). The truly ludicrous naming reflected the openness of insider dealing during loans for shares. Smolensky and Berezovsky bought a 51% stake in Sibneft for $100 million, expanding Berezovsky's eclectic holdings further.[86]

Daniel Treisman, in his article "Loans for Shares Revisited," argues however that criticism of loans for shares is overblown. He holds that initial price assessments of shares being auctioned were unrealistic because they failed to take into account the

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[84] Dmitry Dokuchaev. "'Don't rush to sell Yukos' three large banks say to authorities"(Не спешите продавать "Юкос" - обращаются к властям три крупных российских банка) Izvestia, November 28th, 1995.
[85]Yaroslav Shimov "The State Has Decided to Buy a Little Menatep" (ГОСУДАРСТВО РЕШИЛО КУПИТЬ НЕМНОГО "МЕНАТЕПА"), *Izvestia*, February 16th, 1995.
[86] Goldman, 65

massive liability inherent in these enterprises ranging from the financial risk (most of these companies were hugely in debt and very inefficient) to political risk (communist victory in the 1996 elections looked initially assured). The risk inherent in these companies was made obvious in 1997 (after loans for shares' completion) when auctions of shares of Tyumen Oil, Eastern Oil, Slavneft, LUKoil, and Rosneft were postponed because no one wanted to bid on them, including foreigners.[87]Considering the financial state of companies up for auction and the political risk from impending elections, Treisman argues that the discounted price oligarchs paid is unsurprising and in line with discounts other developing countries give to national businessmen.[88] Finally, he argues that the oligarchs did not just steal their property and rob them of value (as Berezovsky did with Avtovaz) but in fact hoped to develop their value. While oligarch run companies initially reduced value of the shares to squeeze out minority shareholders,[89] once their holdings were consolidated, oligarchs invested heavily in developing their assets and improving efficiency, production, and profit.[90] Treisman holds that loans for shares allowed oligarchs to develop their private enterprises, improve corporate governance, and further the economic reforms that Yeltsin's team had hoped for.

Lieberman, Viemetra, and Treisman's accounts largely miss the significance of loans for shares for Russia's political and economic development. The valid downsides noted by Lieberman and Viemetra of loans for shares were necessary evils from the Yeltsin team's standpoint in order to prevent the undoing of all reform. Binding the oligarchs to

[87] Treisman, 215
[88] Ibid, 218
[89] Khodorkovsky famously stripped Yuganskneftegaz, a Yukos subsidiary, to shake off a foreign investor who eventually surrendered his $1 billion investment (Goldman, Marshall "Petrostate" 108)
[90] Treisman, 225

their political position using a corrupt property transfer was a desperate but ingenious move that would bring Yeltsin to victory in 1996. The government had unified competing oligarchs under the banner of reform to save them both from a Communist victory. Lieberman and Viemetra are right to point out the jaw dropping levels of insider scheming within the loans for shares deal, but the policy was not intended to be a transparent program of reform. Yeltsin's government followed through on loans for shares in a desperate effort to save his presidency.

Treisman's observation that the oligarchs improved their companies after the auctions is more understandable in the oligarch' context of political interest as well. The development of the auctioned industries improved their profitability and gave the oligarchs greater independence from political patrons and networks of "joint responsibility" in business. The oligarchs were happy to push out minority shareholders because they were concerned over securing their own financial position, not the progress of Yeltsin's reforms. The priorities of Yeltsin's reforms and the oligarch's financial interest lined up in 1996, and Yeltsin's team used loans for shares to leverage that shared interest, but shared interest in outcome is not shared motivation. The oligarchs had little interest in reform as an ideological concept because informal connections had remained the basis for financial success. They aimed only to improve their bargaining position within these networks of mutual interest, not overhaul the system. Loans for shares reinforced the idea that success was attained by circumventing formal procedures of democracy and the free market.

A Short Lived Alliance

The rivalry between oligarchs and their networks of joint responsibility that intensified during voucher privatization continued during the mid-1990s despite the cooperation Loans for Shares suggested. Factional conflict was especially evident in the sale of Svyazinvest, a telecommunications giant that was put up for sale by the government in 1997, highlighting the growing conflict between Vladimir Potanin and Boris Berezovsky. Potanin bought a 25% stake in Svyazinvest (for a total of $1.875 billion in a joint purchase with George Soros who later called it the worst investment of his life).[91] The auction excluded Berezovsky because Potanin was willing to pay a high price for the shares, allying himself with Chubais and Nemstov. Berezovsky proceeded to use his influence in media to discredit the reformers, and Nemstov in August of 1997 accused Berezovsky of using his position in the Russian Security Council and his control over media outlets to pressure his government about the Svyazinvest auction, and Berezovsky was fired from his Security Council Position that September.[92] Berezovsky returned the favor by exposing a corrupt book deal between Chubais and Potanin and accusing Chubais of corruption during the auction of oil company Rosneft, eventually unseating Chubais in March of 1998 from his post of First Deputy Prime Minister.[93] Berezovsky further discredited reformers by publishing in his newspaper *Nezavisimaia Gazeta* a leaked letter from the IMF director to Prime Minister Chernomyrdin, detailing IMF displeasure with Russian economic reforms.[94] The fallout from the Svyazinvest deal, which became named the “War of the Banks,” was only ended by Yeltsin’s demand

[91] Martin Gilman,. *No Precedent, No Plan: Inside Russia’s 1998 Default.* (Cambridge: MIT University Press, 2010),89
[92] Ibid, 91
[93] Ibid, 117
[94] Ibid, 131

in 1998 that the oligarchs get into behind economic recovery and stop bickering.[95] Yeltsin's admonition demonstrated the central role of the President, but such moments of decisiveness were rare under Yeltsin. Economic turmoil had increased the potential for factional conflict and Yeltsin could only try to limit the damage of these rivalries on the economy.

Despite this continued competition between political-financial networks, the industrial rewards bestowed on the oligarchs facilitated further success and influence. The oligarchs' ownership enterprises gave them an independent revenue stream that increased their influence within their network of connections. Owning meaningful assets afforded the oligarchs greater independence from intermediaries to grant them access to an enterprise's cash flow. Industrial assets particularly were resilient sources of income rather than the more dependent and fickle industry of banking.

After Loans for Shares, the oligarchs at least had reason to develop their firms along typically capitalist lines since their success depended on the profitability of their firms rather than the oligarch's ability to extract money from government enterprises. However, the relationship of informal, mutual support between business and state remained because the oligarchs had learned the new extent of power that political influence could offer them. The state remained an important supporter of the oligarchs' enterprises and the oligarchs remained invested in government bonds. The industrial assets oligarchs gained during Loans for Shares would prove essential to their continued survival when their profits from banking and finance plummeted.

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[95] Hans-Henning Schroder. "El'tsin and the Oligarchs: The Role of Financial Groups in Russian Politics Between 1993 and July 1998," *Europe-Asia Studies.* Vol. 51, No. 6, 1999. 978

Surviving Collapse

The years after Loans for Shares brought Russia's post-Soviet economy its first major boom and bust. The economic collapse of 1998 and Vladimir Putin's arrival to the presidency in 1999 destabilized the oligarch's financial position and allowed new oligarchs to come into power. Government actions continued to reinforce the importance of joint responsibility arrangements although it modified their internal dynamics. The economic crisis gave rise to rampant bankruptcy that threatened the oligarchs' gains and the government's response ensured the centrality of political influence to the oligarchs' continued survival. Putin, as Prime Minister and then President, used his popularity to expand his control over Russia's oligarchs and businesses, beginning with a reassertion of state authority at Gazprom. Putin then used Gazprom and state force to nationalize Berezovsky and Gusinsky's media assets, demonstrating that Putin could now police the oligarchs into proving their loyalty through their business holdings. Putin had not ended the battle for assets and profit between cliques of officials and businessmen but had ensured that the state interest, as defined by Putin, took precedence.

The Russian economy seemed to be improving in 1997, but its banking system remained a complete mess. Setting aside the oligarchs' banks that acted more often as holding companies after loans-for-shares, banks were generally token affairs that acted as the treasury of their parent enterprise. Although the Central Bank of Russia (CBR) attempted to institute minimum bank reserves that could curtail the growth of "pocket banks," commercial banks were given three years to comply and in 1999 the requirement was waived.[96] Lack of substantive regulation facilitated capital flight and persistently

[96] Gilman, 60.

corrupt relations between banks, enterprises and the government. Despite IMF advice to the contrary, the Russian government pushed ahead with integrating the nascent Russian capital market with the international system, opening the door to foreign investment but also the tumult of international markets.

The government's eagerness to open Russia's economy to the rest of the world is understandable considering the dismal situation Yeltsin found the economy in after the 1996 election. The Russian economy shrunk by 3.6% in 1996, despite predictions of modest growth, further threatening Russia's economic reform program.[97] In the summer of 1997, Russia's attempts at improving its economic position by expanding its capital markets were obviously failing. GKOs were opened fully to international investors, in the hopes of bringing in new capital, but those investors were already pulling out, further draining the CBR's reserves.[98] The CBR estimated it would lose over a third of its $15 billion reserves by the year's end from GKOs alone, not including unpaid taxes and other expenses. Taxes were often negotiated with tax authorities ad hoc, rendering taxation even more inconsistent. To bolster dwindling tax rates, The Russian government created the Emergency Tax Commission to get the largest debtors to pay in cash. Although the result was an impressive 64% jump in tax revenue by pressuring massive companies like Gazprom, the practice reinforced negotiated taxes. It may have even reinforced the loss of some of these funds since many tax payments were collected through oligarch owned banks.[99] The collection of domestic economic problems and international financial turmoil was too much for the Russian banking system and economy. On August 17th,

[97] Ibid, 64
[98] Ibid 107
[99] Vadim Volkov. *Violent Entrepreneurs: The Use of Force in the Making of Russian Capitalism.* (Cornell University: Cornell University Press, 2002), 177.

1998, the Russian government declared bankruptcy, in the process bankrupting hundreds of commercial banks, primarily invested in GKOs.[100]

The government's default and ensuing collapse of the Russian stock market upended the oligarchs' business interests. The oligarchs' banks suffered huge losses, even those banks which had disposed of GKOs during Russia's financial meltdown, and so the oligarchs survived by focusing on their industrial assets. Signs of trouble for Russian oligarchs' banks began by the end of 1997, when foreign investors had begun pulling out of the Russian securities market. They began cashing in GKOs and sapping the CBR of reserves, cutting deposits from GKOs by over a third in a few months.[101] Tax revenues plummeted despite pressure on major companies like Gazprom and Lukoil as enterprises only paid 20% of taxes in cash, the rest in tax offsets and payment liabilities.[102] Inflation undermined what revenues the government was able to collect and an economic crisis coming out of Asia ensured that foreign investors were too panicked to invest new funds in the Russian economy. The Russian government was going bankrupt, threatening the networks of mutual interest between officials and businesses reliant on state funds.

Well-connected oligarchs were tipped off before the announcement of bankruptcy on August 17th, 1998, giving them time to sell government securities and convert ruble holdings to dollars.[103] Even so, many oligarchs barely survived the crisis, and none did so unscathed. Khodorkovsky's Menatep went bankrupt but Khodorkovsky kept his business empire by centering it on the still valuable Yukos and transferring Menatep's

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[100] Goldman, 75
[101] Gilman, 107
[102] Ibid, 134
[103] Goldman, 76

assets before bankruptcy to a new company, creatively named Menatep St. Petersburg.[104] Potanin's Interros lost its assets in manufacturing, oil, and telecommunications, and his bank Uneksimbank followed Menatep's strategy of asset relocation, but Potanin named the new bank (more interestingly) Rosbank.[105]

The businesses that survived the 1998 crisis did so by preserving valuable assets and cash flow in order to ward off creditors and expand their assets in swiftly changing economic and political conditions. Khodorkovsky, through the "new" Menatep St. Petersburg and his oil company Rosprom, used the oil profits of Yukos (Rosprom's primary subsidiary) to pay off debts and buy off minority shareholders, finally consolidating control over Yukos in 1999. Khodorkovsky expanded further after recovering from the crash and secured control over Yukos. In 2001, he expanded his business holdings to Norway, Slovakia, and Kazakhstan. In 2002, Khodorkovsky moved into gas production, buying Rospan, a subsidiary of Gazprom and began purchasing many regional power stations.[106] Although hurt badly by the 1998 crash, Potanin's Interros survived by concentrating on the metals sector, particularly in the massive nickel producer, Noril'sk Nickel. Expansion into metals, particularly the lucrative export nickel, allowed Potanin to similarly pay off debts and then expand into agriculture with the Interros subsidiary Agros, formed in October 2001.[107]

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[104] Barnes, Andrew. "Russia's New Business Groups and State Powers" *Post Soviet Affairs.* 19, 2., 2003, 164
[105] Ibid, 165
[106] Ibid, 164
[107] Ibid, 168

New Oligarchs and the Metals War

Changes in bankruptcy law opened more enterprises to hostile takeovers, allowing new oligarchs to rise in importance. The oligarchs had survived and prospered up to the 1998 financial crisis by exploiting connections with the government to best take advantage of changing economic conditions. These connections had insulated oligarchs' business interests from classic capitalist economic concerns and merged economic with political interest. Political connections had ensured privatization by private agreement, kept prices for assets low, and largely excluded foreigners from taking up controlling interests in the economy. The financial crisis introduced pervasive debt and with it massive instability of property ownership. The same year as the crash, a bankruptcy bill was passed allowing creditors to begin bankruptcy proceedings after 90 days of unpaid arrears.[108] Creditors and those businesses with cash were empowered to reorganize ownership of the economy, and political connections were to remain equally indispensible as before.

Joint-responsibility networks between the oligarchs and officials determined the division of property and revenue, but the economic crisis weakened these networks to allow for a redistribution of wealth among the oligarchs. As business enterprises went bankrupt, oligarchs struggled to maintain control over their assets while new businessmen saw an opportunity to expand. The dynamics inherent to *krugovaya poruka* ensured that mutual benefit and loss, intensifying competition between business rivals. The financial weakness brought on by government bankruptcy opened business to new oligarchs, bringing with them new conflict.

[108] Ibid, 160

Martin Gilman, in his length apology for the IMF No Precedent, No Plan, argues that factionalism was rooted in the corruption of Prime Minister Viktor Chernomyrdin's team during Yeltsin's presidency. The Prime Minister had brought Russia to such a deplorable state by encouraging bureaucratic favors for "backing by powerful groups and factions."[109] Such patronage encourages infighting, the "unconscious" result of which was increased government subsidies for enterprises despite a ballooning deficit. On March 23rd, 1997, Yeltsin sacked most of Chernomyrdin's team, replacing it with a group of reformers and eventually putting reformer Boris Nemtsov at the post of First Deputy Prime Minister who served alongside deputy Prime Minister Anatoly Chubais, a major proponent of further economic reform. Gilman argues that "the oligarchs considered [Chubais] just another competing head of a rival faction."[110] Politics was just one field of competition for the oligarchs, complementing their struggle for financial and industrial assets.

A new group of businessmen leaped into the struggle for industrial assets causing "The Metals War." This group, which has been dubbed by political scientist Yakov Pappe "Bolshaya Madam", or "big madam," represented the new dynamic as it transformed the metals industry during the "metals war." The name is an abbreviation of the five main members: Makhmudov, Abramovich, Deripaska, Abramov, and Mel'nichenko.[111] Two are of particular interest for their success in navigating the post crisis economy: Roman Abramovich and Oleg Deripaska.

[109] Gilman, 64
[110] Ibid, 82
[111] Ibid, 167

Abramovich had been a little-known commodities trader and likely a low level hustler after the fall of the Soviet Union. In 1992, a warrant was put out for his arrest concerning a scheme involving the disappearance of 55 tanks of diesel fuel, worth around 4 million rubles,. although charges were mysteriously dropped and the case left unresolved. From 1993-1996, Abramovich was the head of a Moscow office of Runicom S.A., a Swiss trading firm.[112] Abramovich's connection to this trading firm may explain why Berezovsky chose Abramovich as a partner. Berezovsky, as noted before, had extensive experience using Swiss front companies to keep financial dealings opaque and funnel money out of the country. In 2004, the European Bank for Reconstruction and Development asserted in a confidential memo that Sibneft became the de facto "shadow director" of Runicom and Abramovich had turned the company into a "tax efficient" way to sell Sibneft's oil.[113] Berezovsky owned assets in Sibneft through Joint Bank Logovaz, another financial extension of Logovaz, the company Berezovsky used to bleed profit from automaker Avtovaz and which was also established through questionable Swiss intermediary firms.[114] In September of 1996, Abramovich and Berezovsky had strengthened their control over Sibneft using another rigged auction with front companies owned by Abramovich to acquire another 19% of Sibneft's shares.[115] While Berezovsky busied himself with his media holdings, Abramovich had maintained Sibneft as a source of income insulated from stock market collapse and government default. By 1999,

[112] "Who are you, Roman Abramovich?"[Кто вы, Роман Абрамович?] *Komsomol'skaia Pravda,* July 3rd, 1999.
[113] John Sweeney and Richard Behar. "Bank to sue Abramovich over '9m debt.'" BBC News. January 16th, 2005.
[114] Grigory Vasilyev. "Sibneft takes a gas station loan" [Сибнефть>' берет бензозаправки взаймы] *Sevodnya*, July 16th, 1997.
[115] Pyotr Sapozhnikov. "Who is Roman Abramovich?" [Кто такой Роман Абрамовмч,] Kommersant, November 27th, 1998.

Abramovich had helped found or co-found over 40 companies and was considered the true owner of Sibneft.[116]

Abramovich joined with Deripaska and the two expanded voraciously from 1998-2000 in the metals industry. Deripaska had followed a similar route to success as Abramovich, working as a commodity trader during the early 1990s before buying the Sayansk Aluminum Plant, forming the aluminum company Siberian Aluminum, or SibAl.[117] Their aggressive expansion in the metals industry caused the "Metals War" between the Bol'shaya Madam group and two established companies, all curiously run by brothers- MIKOM, owned by Mikhail and Yuri Zhivilo, and Trans-World Group (TWG) run by David and Simon Reuben and Lev and Michael Cherney. In August of 1998, Deripaska's Sibal used the new bankruptcy law to acquire extensive aluminum and production facilities from MIKOM and shortly after Abramovich used Sibneft resources to acquire aluminum assets from TWG. Aluminum in particular was known as one of the most criminalized sectors of the Russian economy. Light was shed on the messy criminal details during a lawsuit filed in 2006 by Michael Cherney, in the Commercial Court of London. The dispute centered on the relationship between TWG partner Cherney and Deripaska. Cherney said that he and Deripaska had been business partners in SibAl, entitling him to profits, while Deripaska argued that Cherney had been SibAl's "krysha," or mafia protection, and had regularly extorted Deripaska. One judge who heard the case wrote that "One side or other is plainly telling lies on a grand scale."[118] The two settled out of court in 2012, but the case showed that throughout the 1990s, the metals sector was

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116 "Who are you, Roman Abramovich?"[Кто вы, Роман Абрамович?] *Komsomol'skaia Pravda,* July 3rd, 1999.
117 Barnes 167
118 Catherine Belton. "Rusal: A lingering heat" *Financial Times*. January 25th, 2010

one of the most lucrative and the most violent.[119] To avoid further contestation, Abramovich and Deripaska created Russian Aluminum, or RusAl, as a 50-50 partnership that combined the assets of Sibal with Abramovich's holding company Millhouse capital. The two oligarchs now owned a company that controlled 75% of the Russian aluminum market.[120]

Putin Ascendant

On the heels of upending economic crisis, Vladimir Putin's presidency changed the oligarchs' calculation of personal benefit. He was appointed Prime Minister on August 9th, 1999 and despite initial uncertainty of his authority (he was the fifth prime minister in less than 18 months), he quickly used Chechen bombings in Moscow[121], renewed conflict in the North Caucasus, and his resulting popularity to strengthen his influence and quickly began an upheaval among the oligarchs.[122] He was appointed President when Yeltsin stepped down unexpectedly in December of 1999 and went on to win election in 2000. Putin brought new vigor to the presidency and sought to reassert the primacy of state interests over the oligarchs' profit motive.

Putin expelled Gusinsky and Berezovsky from the country when they threatened Putin's popularity and by extension the interest of his government. Both magnates were politically influential through their media outlets, and critical coverage of Putin was a powerful weapon against a still new president. However, the oligarchs' reliance on state support was a weakness that opened their businesses to takeover. Oligarchs' profits from

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[119] Luke Harding. "Deripaska and Cherney make surprise deal out of court" *The Guardian*, September 27th, 2012.
[120] Barnes, 168
[121] There have been accusations that these bombings were actually organized by some of Putin's former colleagues to garner support for the new President. The subject, while very interesting, is also well beyond the scope of this paper.
[122] Hoffman, 465

their connections were also criminal and meant that the oligarchs could be personally targeted as well as financially. These connections also aligned the oligarchs with certain political factions, some favored and others mistrusted by Putin.

Gusinsky's connection with Moscow Mayor Luzhkov and criticism of Putin was his undoing. Putin's Chief of Staff, Alexander Volshin had asked for Gusinsky's support during the 2000 elections, to which Gusinsky fatefully replied that Putin could not expect a repeat of 1996, and pushed ahead with support for Luzhkov.[123] Berezovsky, happy to support Putin and discredit his longtime rival, orchestrated a devastating smear campaign through ORT which doomed any of Luzhkov's executive dreams as Putin's popularity continued to climb. Putin grew to personally hate Gusinsky and targeted Gusinsky for his support of Luzhkov and what Putin perceived as Gusinsky's support of American interests in Russia. In short Gusinsky was not "a Putin man."[124]

After Putin's election in March of 2000, he proceeded to destroy Gusinsky's influence in Russia, using Gazprom as his instrument. Putin used state influence in Gazprom "as private owners operate their conglomerates-i.e. using debts, courts, and state sponsored force to tighten control over their associates' enterprises."[125] Gusinsky's NTV had been partnered with Gazprom throughout the 1990s, and Gusinsky had no reason to suspect that Gazprom's 30% share in NTV could pose a danger. Gazprom had loaned NTV hundreds of millions of dollars over the course of the 1990s, acting as a cushion of capital throughout for Gusinsky and buffering NTV from the 1998 crisis.

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[123] Hoffman, 471
[124] Ibid, 475
[125] Barnes 175

Under pressure from Putin's administration, Gazprom called in all of its loans, refusing NTV's equity but instead demanding cash it knew Gusinsky did not have.[126]

Gusinsky's Putin problems extended beyond his media holdings. In May of 2000, desperate for cash, Gusinsky hoped to sell his Most Bank to a CBR subsidiary but the chairman of the CBR was called personally by Putin to prohibit the deal. On May 11th, three minibuses of armed, masked men stormed the headquarters of Media-Most, identifying themselves as tax police, in an incident reminiscent of Gusinsky's brush with presidential power in December of 1994.[127] Gusinsky was charged with fraud relating to his dealings with a company named Russian Video, giving the authorities an excuse to further harass him and throw him in jail for a few days. Under mounting pressure, Gusinsky was forced into a deal whereby the government would pay Gusinsky $300 million in cash and forgive his $473 million debt to Gazprom, in exchange for all of Gusinsky's empire, Media-Most, and NTV. Shortly thereafter, the Russian government dropped charges and Gusinsky fled the country.[128] By April of 2001, Gazprom had finalized its control over all of Gusinsky's former media assets.[129] The political patronage which had secured Gusinsky's rise had become instrumental in his downfall.

Putin redefined the relationship between the oligarchs and the government by making state interest, enmeshed with his own political interest, take primacy in state-business relations. Berezovsky's expulsion demonstrated the heightened importance of the state's interests in the oligarch's relationship to the state, even over that of the personal loyalty implied by *krugovaya poruka* groups or Berezovsky's support of Putin in

126 Hoffman, 478
127 Ibid, 477
128 Ibid, 483
129 Ibid, 485

the 2000 elections. Mutual benefit was understood now to be a business's right to ownership and the state's right to guarantee its interests by revoking or modifying that right or ownership, especially if that business threatened the revival of presidential and federal power.

Berezovsky's initial support of Putin in the 2000 elections might have guaranteed his security at first, but relations between the new president and the old-guard oligarch deteriorated quickly after Putin's inauguration. Berezovsky had won a seat in the Duma on December 19th, 1999, campaigning in support of Putin and had supported him through his media outlets.[130] The government proved to be a lifeline for these media companies since the state owned a 51% stake in ORT (although Berezovsky still controlled the company) and state bank Vneshekonombank provided $100 million in loans to help ORT survive the 1998 crisis.[131] However, differences emerged once Putin had secured the presidency. Putin embarked on sweeping constitutional reform that would impose 7 unelected "super-governors" to rein in the 89 regional chiefs who had run the provinces like personal fiefdoms.[132] In May of 2000, Berezovsky publically broke with Putin, issuing a letter criticizing what Berezovsky argued was Putin's growing authoritarianism. In July, Berezovsky resigned from his post in the Duma, saying he could no longer participate in "the establishment of an authoritarian regime."[133]

Berezovsky's criticism went too far when his news channel ORT began attacking Putin's leadership at a particularly delicate moment. In August of 2000, a nuclear submarine the Kursk sank, killing all 118 on board. Berezovsky's ORT took the lead in

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[130] Klebnikov, 316
[131] Hoffman, 470
[132] Ibid, 486
[133] Ibid, 487

criticizing Putin for not acting decisively and treating the loss of life callously. Shortly thereafter, Voloshin called Berezovsky to say that "either you give up ORT in two weeks or you will follow Gusinsky."[134] Vneshekonombank demanded the return of its loan, putting Berezovsky in the same position that Gazprom had forced Gusinsky into.[135] Berezovsky realized the futility of fighting Putin, and sold his interest in ORT to Sibneft partner Roman Abramovich, who had demonstrated greater cooperation with Putin, and fled the country.[136] Less than a year after Putin's election, all three national television stations were controlled by the state.[137]

The state's assumption of Russia's three national television channels protected Putin from early challenges as he solidified his initial wave of popularity into a base of support for continued political tenure. Especially as the war in Chechnya continued, critical media became an immediate threat to Putin's expansion of centralized power. In his paper "Factionalism and Russian Politics," Richard Sakwa argues that the after "the defeat of Berezovsky and Gusinsky…no substantial opposition remained in Society" for Putin.[138] Putin sought to create a "new breed of Kremlin 'oligarchs'" subordinate to his authority as he consolidated control over a country used to Yeltsin's chaotic governance.[139] Putin would not change the oligarchs' system, only reorient it and shuffle its personnel. Doing away with Berezovsky and Gusinsky reinforced the importance of the state within the networks of connections uniting business and government. Putin

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134 Ibid
135 Barnes, 176
136 Hoffman, 489
137 Masha Gessen. *The Man Without a Face: The Unlikely Rise of Vladimir Putin*. (Riverhead Books, 2012), 174
138 Sakwa, Richard "Factionalism in Russian Politics." CEELBAS Public Policy Conference, 'Russia Beyond 2008', St Antony's College, Oxford, 15 December 2007. 15

139 Ibid

secured his own political survival by exploiting these connections, and would perpetuate the oligarchs' reliance on their connections to the state for success.

Sakwa's observations on Putin's political strategy reflect the factional nature of *krugovaya poruka* groups that had fueled conflict during voucher privatization and after the 1998 economic collapse. Putin had perpetuated this factionalism, leaving oligarchs to constantly negotiate their position relative to the government. Gilman's earlier account of corruption fueling factional conflict ignores the deeper roots of financial-political networks in Russian governance. Politicians' loyalty or interest in various oligarchs' businesses plus renewed state power turned the oligarchs into subjects of a central authority, boyars to the Presidential Tsar. Factions still competed with one another for political and economic benefit, but President Putin would always be final arbiter and the state's interest would take precedence over factional spats.

The continued scramble for assets between rival businessmen, and the new rules of competition, were evident in the sale of state owned oil company Slavneft. In 2002, the Russian government hoped to sell 20% of Slavneft, initiating a feud between Abramovich's Sibneft and Rosneft that involved a slew of lawsuits, confrontations between security services, and bomb threats.[140] The incident reflected the extent to which insider deals pervaded the system, a fact neither Putin's popularity nor his new political strength could change. The government consented to selling 75% of Slavneft instead of the original 20%, ostensibly to have a cleaner, more transparent auction. However, the auction was obviously rigged in favor of Sibneft, excluding all major competitors who found the auction even less attractive given that Sibneft bought many of

[140] Hoffman, 489

Slavneft's assets in advance of the auction.[141] Putin could insulate the state from being victimized by the business interest of the oligarchs, but the system of factional feuding and *krugovaya poruka* groups remained in place. He would continue his pursuit of power, keeping the oligarchs and their enterprises in mind.

[141] Barnes, 179

Boyar Capitalism

Boris Yeltsin once told his ministers that he was their Tsar, and they his boyars, an old Russian word for court nobles. After Putin's initial consolidation of power, he began a policy best described by scholar Marshall Goldman as "The National Champions" program. The implementation of the National Champions policy was a new definition of the state interest within the energy industry that the oligarchs were forced to adapt to after the arrest of Mikhail Khodorkovsky. Putin executed this policy by installing those loyal to him in positions of influence within the energy industry and others, taking advantage of the informal system of loyalities which existed before. However, not all who secured a niche in Putin's Russia came from the camp of loyalists, notably the oligarchs. Khodorkovsky presented a threat to Putin's power and the National champions policy and so he had no place in Putin's forming order. He used the oil company Yukos for precisely the reason Putin valued it, for its potential politically, and therefore his ownership of Yukos could not be tolerated. The oligarchs who survived did so by proving their loyalty to Putin and aligning themselves and their business interests to Putin's new definition of state priorities. Most learned by Khodorkovsky's example to abide by Tsar Putin.

However the oligarch's role during the implementation of this policy has remained largely murky, and academics have offered a barrage of interpretations. Anders Aslund argued in a 2006 article in Foreign Policy that Putin's government should have protected these oligarch-owned companies rather than crusading against them, lamenting Putin's inexplicable ignorance of the oligarch's importance.[142] Marshall Goldman has

[142]Anders Aslund. "The Hunt for Russia's Riches. Foreign Policy." January-February 2006, 44

taken issue with Aslund's account, and argues in his book Petrostate that Putin's decision to act against the oligarchs if anything, showed his recognition of their importance. He holds Berezovsky and Gusinsky's exile reflected that they did not belong to the same political clique as Putin, composed of former intelligence agents and St. Petersburg associates. Khodorkovsky stood in the way of Putin's plans to assert state control over the oil industry and so he was imprisoned. David Hoffman argues that "oligarchic capitalism" as developed under Yeltsin was reinforced by Putin's attack on the oligarch's power because it discouraged Western standards of business and brought back the chaotic scramble for assets that characterized Russia before 1997.[143]

Hoffman and Goldman's accounts offer a better explanation of what Putin changed in Russian politics and in relation to the oligarchs but some questions remain. By Goldman's argument, how did oligarchs survive Putin's expansion of state control in the energy sector, even those oligarchs in vital industries like oil? If Hoffman is right that Putin reinforced a battle for property while keeping oligarchic capitalism, why did the economy stabilize and prosper for over a decade rather than descend into the near anarchy of the early and mid-1990s? Studying the oligarchs who survived and their actions before and after Khodorkovsky's arrest can provide clues to both Putin's changing stance towards the oligarchs and the economy structure he was creating. Putin's assertion of state control over lucrative, strategically vital industries sits at the center of how Putin made himself Tsar over the oligarchs.

The state's expansion of influence in strategic industries, notably oil and gas, was dubbed "The National Champions Policy" and became possible after the Russian economic recovery following the 1998 crash. Rising commodity prices and the success of

[143] Hoffman, 499

energy companies, mainly in oil, propelled economic growth during Putin's first years. This recovery increased the political potential of sprawling industrial complexes, especially within energy production, and made securing their loyalty much more urgent. The policy was based in a thesis Putin wrote for the St. Petersburg Mining Institute in 1997 in which he argued for a reassertion in state authority over energy firms in particular and although Russia should encourage foreign investment, it should only do so to make Russia more competitive internationally, and never allow foreign control over key assets.[144]The government needed to ensure that companies valuable to the national interest put country above profit.[145] Putin's political power in his first term allowed him to harness the immense profitability of oil and gas to the advantage of the state. The Russian government's ownership of the oil industry reflects this change of his policy: in 2000, the Russian government owned 16% of national oil production but by 2007, it had expanded to owning 50%.[146]

In order to prevent Russia's vast energy corporations from selling off national wealth, and potential political power in the process, Putin used the state's already close relationship with businesses to reclaim control over energy resources, beginning with Gazprom. Daniel Treisman argues that beginning in 2000, Gazprom acted as an "all purpose vehicle for Kremlin business." [147] Gazprom's importance was not accidental: the government could control businesses by use of legal organs, such as the tax service or state ownership of shares. Gazprom, as one of the least reformed, least privatized, companies was one of the easiest to control. The state was an important shareholder in

[144] The thesis was in large part plagiarized from two analysts at the University of Pittsburgh but regardless the idea itself had a history in European politics for at least 50 years.
[145] Goldman, 97
[146] Ibid, 99
[147] Treisman, Daniel. "Putin's Silovarchs" *Orbis*, Winter 2007.144

Gazprom while tax evasion and asset stripping went on rampantly under its head Chernomyrdin (who after his dismissal from Prime Minister was able to head the company he in effect created during privatization). Many of the entrenched red directors within Gazprom created a firm ITERA, which had been systematically raiding Gazprom and was based abroad where the profits could not be confiscated. Putin therefore had ample means and excuse to purge Gazprom of its management. He forced ITERA into bankruptcy to regain some of the stolen funds and removed the former Nomenklatura from management positions at Gazprom, removing as well Chernomyrdrin from the top post.[148]

Once made vulnerable to government control, Gazprom absorbed many assets of the formerly powerful oligarchs: obtaining most of Gusinsky's media empire through its subsidiary Gazprom Media and later buying Abramovich's Sibneft. Another Gazprom subsidiary, Gazprominvestholdings expanded its ownership of media and telecommunications under the leadership of Alisher Usmanov, a Putin confidant with a fairly murky past.[149] While this included the remains of Berezovsky's media assets except for ORT, the company has also been a vehicle for Usmanov to be a tycoon of 21st media and telecommunications, particularly in internet services, social networking, and mobile phones. He may also hold funds from numerous people within Gazprom and the government, to ensure that while money still is stolen through Gazprom, the proceeds can be revoked by Putin.[150] Usmanov's position demonstrates that Gazprom became Putin's

[148] Goldman, 104
[149] Usmanov is widely thought to belong to organized crime and be a middleman for handling and transferring Russian officials' corrupt earnings and managing sensitive government expenditures. As one banker I spoke with commented "The real stuff you won't find in any newspaper, it's all rumors"
[150] Interview with Natasha Kagalovsky

corporate vehicle for asserting control over the oligarchs and the network of informal connections underpinning their success.

Making the New "Putin Man"

Another method by which Putin ensured the loyalty of essential industries was installing trustworthy personnel in important positions. Goldman calls one cadre of Putin loyalists to be those he worked with in the St. Petersburg government, called the "Friends of Putin," or in Russian, the "Peteri." Putin appointed colleagues from St. Petersburg to be ministers of finance and trade.[151] After Putin expunged the old red directors from Gazprom and forced Chernomyrdin from the top position, in 2000 he installed other St. Petersburg associates Dmitry Medvedev and Alexei Miller to head the company and ensure better performance and loyalty to Putin's government. Putin also brought former security service officers, named the Siloviki, in the economy creating what Treisman calls Silovarchs. These loudly patriotic spies-turned-businessmen did poorly at the job overall, one former Russian banker called them flat out "stupid,"[152] but acted as placeholders for government influence.

As these groups came to inhabit the Russian business landscape, the remaining oligarchs jockeyed to find a place as the rules of the game swiftly changed around them. The key was proving loyalty to Putin. Goldman argues that Gusinsky and Berezovsky were exiled, rather than just stripped of their assets, because they were "not ours"- not natively Russian (both Berezovsky and Gusinsky were Jewish), had ties to organized crime, were not part of the old communist nomenklatura, and therefore could not be

[151] Goldman, 96
[152] Interview with Natasha Kagalovsky

trusted by Putin.[153] However this argument ignores the oligarchs who survived Putin's first term. Khodorkovsky's early success was built on his ties to the communist party but he was arrested whereas Oleg Deripaska fled his university job as a physicist to be a metals trader and despite never being affiliated with the communists is considered a Putin ally. Alisher Usmanov was a virtual unknown until he suddenly entered Putin's good graces and yet was also associated with organized crime, is a Muslim from Uzbekistan, and has a Jewish wife. Roman Abramovich prospered under Putin despite fitting each criterion for ejection that Goldman mentions. The oligarch's success depended on how they could adapt to Putin's changing conception of state interest. Loyalty to Putin's order was what defined being a "Putin man," not mere membership in the security service or St. Petersburg government and certainly not superficial traits like ethnicity.

Khodorkovsky was unwilling to show fealty to Putin's government and so posed a serious problem for ensuring the loyalty of companies in the oil industry. Khodorkovsky expanded his holdings and used Yukos' burgeoning profits to expand his political influence. By the time of his arrest, Khodorkovsky was Russia's richest man, worth around $15 billion, and had begun using his wealth to support growing domestic and international ambition. Yukos was raking in foreign investment and hoping to expand his holdings, partner or sell to a Western firm, and there was speculation about a political career. Khodorkovsky had too many ways to frustrate Putin's hope for control over the oil industry and refused to cooperate with government control.

As Khodorkovsky's Yukos became hugely profitable, it began pursuing closer connections with Western oil companies and foreign governments, directly in conflict with Putin's National Champions plan. As Yukos recovered from the 1998 crash and

[153] Goldman, 96

rebounded with huge profits, Khodorkovsky brought in a raft of foreign managers to bring Yukos into line with international corporate practices, leading to Yukos being listed on the London Stock Exchange.[154] By late 2002, Khodorkovsky was having dinners with important figures within the Bush administration, including Bush Sr. and Cheney, and invested $50 million with the investment company the Carlyle Group, which like Halliburton, was known for its comfy relations with the Bush White House.[155] Bush was looking to diversify American oil important away from the Middle East and many hoped that Khodorkovsky could provide just the support Bush needed. To demonstrate his willingness to do business, Khodorkovsky sent tankers to Houston, breaking the state monopoly on crude exports, managed by the company Transneft.[156] Khodorkovsky pushed even further, signing a contract in May of 2003 with China to begin supplying oil by 2005. He was also in negotiations to sell a significant, possibly controlling portion of Yukos to Exxon-Mobil or Chevron. [157] Khodorkovsky's growing ambitions made him an increasing risk to Putin's program of asserting great control over oil companies.

As his international and financial ambitions grew, he began giving extensive donations to domestic and international organizations while funding political candidates and parties in Russia. He founded a charity, Open Russia, to increase ties between Russia and the West, particularly the U.S. and Britian, initially investing $16 million. He quickly became Russia's largest private philanthropist as well.[158] He also funded political parties, ranging from the liberals to the communists, and had the support of up to

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[154] Goldman, 111
[155] Meier, Andrew. "The Oligarchs Ball-Washington oilman-plutocrats court their Russian counterparts" *Harpers Magazine*, April 2004. 79
[156] Goldman, 111
[157] Ibid, 112
[158] Hoffman 494

100 Duma members. Such support allowed him to block legislation that would have regulated the oil industry more closely.[159] These activities insulated Khodorkovsky from Putin's control by ensuring international attention on Khodorkovsky while building up domestic political support to resist Putin's advances and possibly to prepare to run for President in 2008. Khodorkovsky was using his revenue from the oil industry to fund political power independent of Putin's control, further challenging Putin's consolidation of authority.

While this political activity was by itself worrisome to Putin, Khodorkovsky made the especially aggressive mistake of challenging Putin on live television in February of 2003 when he complained to Putin about extensive corruption within the government and in its management of Rosneft, the state oil firm. "Your bureaucracy is made up of bribe takers and thieves."[160] Putin shot back that if anything, wrongdoing in the private sector should be investigated. First, Yukos' head of security was brought up on murder charges in June and then in July, Khodorkovsky's business partner Platon Lebedev was arrested. Khodorkovsky understood the warning Putin was giving him and was aware of the risks staying in Russia posed. Some of his former associates, who fled shortly after Khodorkovsky and Putin's televised confrontation, say that Putin offered Khodorkovsky up to $1 billion to leave the country.[161] Khodorkovsky however was determined to stay in Russia, attributed by family and friends to a mixture of determination and conviction. A full investigation into Yukos began in October of 2003 and on October 25th, Khodorkovsky was arrested on his private jet as it refueled in Novosibirsk. He was

[159] Goldman, 113
[160] Ibid, 114
[161] Cyril Tuschi. Khodorkovsky (Documentary) Released November 30th, 2011

charged with tax evasion, grand theft, fraud, forgery, embezzlement, and extortion while Yukos was slammed with $33 billion in back taxes.[162]

Khodorkovsky's imprisonment sent a chill throughout the Russian business world, and international observers could not fail to notice the imprisonment of Russia's all-star oil magnate. Many, like Anders Aslund above, remarked that Putin was crusading against the oligarchs and free enterprise in Russia. Yet only Khodorkovsky was targeted. Putin's assault was not so indiscriminate as to threaten the oligarchs, Russia's leading businessmen, as a class. Oligarchs needed to give assurances of their loyalty and reduce the potential risk they posed to Putin's agenda. Others were more flexible than Khodorkovsky in coming to terms with Putin's rules of engagement.

<u>Oligarchs Go Courting</u>

Roman Abramovich quickly understood his own problem as the only other major private owner of oil left, controlling Sibneft. In 2005, Abramovich sold Sibneft to Gazprom, and gave his shares in Aeroflot, and Rusal to the state or to Putin loyalists. In repayment, he was given $13 billion dollars, making him Russia's richest man.[163] Shortly afterwards, Abramovich was appointed by Putin governor of Chukhotka, a far flung and impoverished region of North East Russia. Aslund sees this move as a concession to populist dislike of the oligarchs. He argues that "Putin must somehow find a way to bring the oligarchs into the fold"[164] rather than marginalizing them. Aslund fails to see however that Putin did exactly that, but first ensured that those oligarchs brought into the fold were loyal. Abramovich's giveaway of his assets reflected his own interest in preserving his

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[162] Goldman, 116

[163] Andrew Kramer. "$13 billion Sibneft deal fulfills Gazprom quest" *New York Times.* September, 29, 2005

[164] Aslund, 46

financial position in Putin's Russia. Despite the gubernatorial appointment, which Aslund argues demonstrates Putin's sense of humor, the sale of Sibneft made Abramovich Russia's richest man while preserving his main financial vehicle: Millhouse Capital, an investment firm that would prove Abramovich's lifeline to continued business opportunities.

Abramovich's urge to prove his loyalty is understandable, especially since Sibneft and Yukos had planned a merger. The first attempt had fallen through due to issues in management and the second attempt at a merger was interrupted by Khodorkovsky's arrest. Abramovich kept the $30 million investment Khodorkovsky had made, but still needed an escape. Abramovich had worked with Berezovsky and Khodorkovsky, and needed to show that his association with them or their political cliques was harmless. Ridding himself of oil assets ensured that he would pose little risk to Putin's national champions policy while demonstrating his willingness to put loyalty to Putin over that of short term profit or responsibility to members of either Khodorkovsky or Berezovsky's factions.

Two oligarchs were the quickest to endear themselves to Putin: Oleg Deripaska and Vladimir Potanin. They kept Putin's interest as their own business interest and kept him continually apprised of their business ambitions, furthering Russia's national interest while making a profit in exchange for the restraint of loyalty to the state. Potanin wanted to expand his massive metals firm Norilsk Nickel's assets in the U.S., and did so with the support of the U.S. government and in constant consultation with Putin. Equally important was the type of expansion Potanin envisioned. Where Khodorkovsky wanted to sell the Americans Russian oil, Potanin bought America's only palladium producer, the

Stillwater Mining Company in Montana. The deal gave Potanin's Norilsk Nickel's and almost unchallenged position in the lucrative palladium market and was finalized in June of 2003 only after talks directly between Bush and Putin.[165]

Deripaska was especially successful in earning Putin's favor and as a relative new comer he needed it badly. Deripaska's growing connections during the first half of Putin's first term were demonstrated by his deal in 2000 with Abramovich's Millhouse Capital to jointly manage their assets in the company Russian Aluminum or Rusal. The agreement was finalized in early 2001, when the antimonopoly commission approved the merger, despite the owner's and management's numerous offshore accounts frustrating the government's auditing process.[166] The government's permission to merge suggested Putin's blessing of the oligarchs' business venture. Indeed the commission granted the oligarchs an industrial behemoth. Rusal controled 70% of the Russian aluminum market and 10% of the world market. The head of the commission was Ilya Yuzhanov who was appointed in May of 1999 while Putin was still head of the FSB, but Yuzhanov had worked with Putin in the St. Petersburg government and was kept at his post until 2004.

Deripaska also sought to align himself with Putin's ideology to demonstrate his loyalty to the new president. Beginning in 2000, Deripaska wrote articles for different financial publications detailing his own philosophy of business and his recommendations for the state. The language he used is very similar to Khodorkovsky's writings of the same period in that both oligarchs stressed the need for good corporate governance, payment of taxes, and Western standards of business ethics and accounting. However, where Deripaska differs is his stress on social stability and state-business partnership in

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[165] Meier, 80

[166] Baranov, Anton. "Abramovich and Deripaska officially merge" [Абрамович и Дерипаска официально сочетаются] *Vostochno-Sibirskaia Pravda,* April 4th 2001.

the realization of national interests. In an interview with *Vek*, Deripaska stated "We well understand that the future of our business directly depends on social stability."[167] Stability was one of Putin's favorite buzzwords, and his commitment to stability is what assured Putin high popularity throughout the 2000s. In 2004, after Khodorkovsky's arrest, Putin's intentions for the energy industry had become obvious,

Deripaska also sought to prove loyalty to Putin keeping out of politics, honoring a half-legendary agreement between Putin and the oligarchs. Putin ostensibly met with the major oligarchs after taking office and told them that if they stayed out of politics and paid taxes, they could keep their ill-gotten gains from the 1990s. The oligarchs' absence from politics might evidence that understanding, but no evidence exists for a single meeting where this ultimatum was given. More likely, Putin expressed his dominance in politics over a series of meetings, changing the parameters defining political involvement as he established his own power base. Deripaska wanted his lack of political ambitions to be clear. He restated in an interview with *Nezavisimaia Gazeta* that social stability was essential for Russia's economic health and that such an end could be best achieved by partnership between the state and the private sector.[168] Throughout Putin's first term, Deripaska maintained he had no interest in entering politics, refusing to run for governor of Nizhny Novogorod despite the urgings of his supporters.[169]

The rewards for such displays of loyalty were myriad and demonstrated that Putin was encouraging loyalty in his oligarchs, not purging them wholesale from society.

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[167]Valerii Vikunen. "Oleg Deripaska: The philosophy of business is stability" Олег ДЕРИПАСКА: "Философия бизнеса - стабильность] *Vek*, December 29th, 2000.

[168] Oleg Deripaska. "Преодоление неравенства – путь к долгосрочной стабильности. В России необходимо создать систему мер, с помощью которой активное население сможет реализовывать свои права," *Nezavisimaia Gazeta* February19th, 2004

[169] Natalya Rezontova. "Oleg Deripaska won't go to the governors"Олег Дерипаска в губернаторы не пойдет *Vremya Novostei* , January 6th, 2001

Through his massive holding company Basic Element and his investment vehicle Sibal, Deripaska expanded in industries once dominated by Yeltsin-era oligarchs. Taking over from Berezovsky, Deripaska acquired huge assets in the automobile industry and began expanding his holdings abroad, with the goal of developing the Russian automobile market and integrating it with the world market.[170] Deripaska's Sibal, after the merge just an investment arm of Rusal, began a partnership with the Moscow government to fund large scale construction projects in the city, taking much of Gusinsky's former business.[171] His expanded his holdings in construction, in 2004 winning a contract with the Nizhny Novgorod Public Housing Sector under questionable (i.e. corrupt) circumstances.[172]

Putin kept tightest control over oil, gas, and media and so accordingly few oligarchs entered that business without explicit cooperation of the state. Otherwise, the oligarchs were free if not encouraged to expand their business holdings, so long as the state's authority over their enterprises was unchallenged. Putin preserved the same system of intensive business-state corruption and penetration but has established centralized dominance over business interest. Corruption as a way to enrich individuals and their firms through political-business connections was the basis of his strategy's success. The Russian government's ability to dole out valuable property or rights rested on the system created by the oligarchs and the Yeltsin government in the 1990s, which in turn drew from business practices encouraged by Perestroika. Putin's adroit use of popularity allowed him greater authority to use force and organs of the state to police

[170] "Missionary Deripaska", *Kommersant Daily,* June 26th, 2002
[171] Maria Rozhkova and Yulia Polyakova. "Deripaska is Luzhkov's partner" [ДЕРИПАСКА - ПАРТНЕР ЛУЖКОВА], Vedimosti, November 13th, 2000.
[172] "Олег Дерипаска взял Нижний Новгород," I*zvestia*, February 11th, 2004

loyalty to him, but nonetheless his policy towards the oligarchs during his first term was not a crusade, nor was it based in populism. Putin wanted to guarantee the loyalty of the oligarchs and in so doing, cement the power of his government. The arrest of Khodorkovsky not only marked the beginning of Putin's National Champions policy, but also the final wake up call to the oligarchs. All those who did not leave before then or were arrested in connection with Yukos learned to show deference to Putin and to national interest. Russia's capitalist oligarchs had become boyars.

Conclusion

Vladimir Putin's tinkering with the system of *krugovaya poruka* had deep implications for his governance of Russia's "managed democracy." Putin's expulsion of Gusinsky and Berezovsky ensured that no national television channel would broadcast damning criticism of him. More liberal, critical news outlets would be relegated to print, radio, and blogs, engaging only the intelligentsia. Khodorkovsky's arrest demonstrated that businesses were not sources of personal influence, but rewards for abiding by Putin's rule. Oligarchs like Oleg Deripaska and Roman Abramovich scrambled to find their place in the new order, aligning the interests of Russia's most prominent businessmen with state priorities. Putin had neutered oligarchs' threat to presidential authority, at least for the time being. The oligarchs still relied on networks of political connections to survive and prosper, but these networks would be firmly oriented to respect the state's priorities over individual profit. Faced with individual expulsion or imprisonment, oligarchs in Putin's Russia followed his new rules of business loyally. The Russian state gained an unprecedented authority over Russia's economy when it tamed the oligarchs.

This newfound authority did not represent a break with Russia's political tradition, but the modification of an established order. *Krugovaya poruka* had its roots in Soviet tradition and its economic value was enhanced by perestroika's economic reforms. The oligarchs' financial successes reflected the centrality of joint responsibility arrangements to the functioning of Russian business. Subsequent government policies and official actions only reinforced the dynamics that made informal connections more profitable than legal routes. Voucher privatization kept the oligarchs dependent on semi-private industrial managers and webs of bribery and mutual reliance to support their financial ambitions. Loans for Shares gave presidential endorsement to a system in which businessmen were given preferential means to succeed by virtue of their political connections. Given property from loans for shares auction, the oligarchs had reason to develop their corporations without help from officials and corrupt managers but history intervened. Economic collapse and political upheaval reinforced dependence on political patrons, now under the power vertical of President Putin. Informal links between politics and business were nothing new to Russia and Putin did not diminish their importance. He only ensured that these ties would strengthen his political influence.

This continuity between Putin's order and "oligarchic capitalism" under Yeltsin is evident, but often understated. Despite the infusion noted by Goldman and others of Putin's personnel from St. Petersburg and the security services, Russia's most successful businessmen mostly fit the mold of oligarch, and many are leftovers from the 1990s. The list below is not definitive, but suggestive, of the oligarchs' continued influence in Russian business. It ranks the top 15 of Russia's richest men in 2012 by networth, and I have annotated these names with their categorization. The two main types of businessman on the list are the 1990s oligarchs and the former Soviet directors. These labels are only as helpful as the loose descriptions they connote. Oligarchs on this list got their start in their financial industry during the 1990s before moving on to greater success during the Yeltsin and Putin governments. Former Soviet managers are the "red directors" who formalized their control over Russian industry through voucher privatization.

Russia's 15 Richest Men, 2012[173]

1. Alisher Usmanov-Unknown, possibly mafia.

2. Vladimir Lisin--Former Soviet manager.

3. Alexei Mordashov- 1990s oligarch.

4.Vladimir Potanin- 1990s oligarch

5.Vagit Alekperov-Former Soviet manager.

6.Mikhail Fridman-1990s oligarch

7.Mikhail Prokhorov-1990s oligarch, began with Potanin

8.Viktor Vekselberg-1990s oligarch

9. Roman Abramovich-1990s oligarch, began with Berezovsky.

10. Leonid Mikhelson- Former Soviet manager

11. Andrey Melnichenko-1990s oligarch

12. Gennady Timchenko-Former Soviet manager

13. Dmitry Rybolovlev-1990s oligarch

14. Oleg Deripaska-1990s oligarch

15. German Khan-1990s oligarch, began with Fridman

Putin's Petersburg and Chekist associates are nowhere to be found near the pinnacles of wealth in Russia. While Goldman compellingly argues for their rise to prominence under Putin, these groups have remained largely unsuccessful in business. Judging from the list above, the field of players in Russian business has changed little in the last decade, except for the disappearance of Gusinsky, Berezovsky, and Khodorkovsky and the meteoric rise of Alisher Usmanov. Putin did not crusade against the oligarchs but has co-opted them into his economic order. So long as the oligarchs show fealty to Putin, their background in the chaos of the 1990s is irrelevant.

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[173] Forbes List of Russian Billionaires, *Forbes.* March 10th, 2012

The dynamics evident in joint-responsibility networks and their development from 1987 to 2004 are suggestive of the dynamics at work within Putin's regime. As noted throughout Russia's post-Soviet experience, *krugovaya poruka* encouraged factional conflict between networks of mutually interested politicians and businessmen. Putin has not conquered this dynamic but learned only to manage it for state benefit. As before, economic turmoil, political weakness, or both may intensify competition between these groups. Putin's ability to adapt to this competition will determine his continued control over the Russian economy. If Putin's state ceases to be the final arbiter of business disputes, the oligarchs' loyalty will begin to unravel.

Moreover, the centrality of informal relations to the Russian political economy helps explain Russia's epidemic of corruption. This corruption has intensified under Putin to truly historic levels, some estimating that bribes total annually around $400 billion.[174] The economic recovery under Putin has increased the flow of money through Russia exponentially. His affirmation of informal networks means that bribery remains essential for all business dealings. The importance of these networks bodes ill for the perpetual, if often insincere, efforts by the Russian government to reduce astronomical levels of corruption.

Finally, the oligarchs continued presence in Russia is meaningful for Putin's hold on political power and the future of Russian democracy. The oligarchs used their influence in politics and business to ensure the result of elections in 1996 and 2000. Putin's expulsion of Gusinsky and Berezovsky and his subsequent policy of National Champions aimed to curb the oligarchs' role as kingmakers. Yet the foundation for this

[174] Vladislav Inozemtsev. "Neo-Feudalism Explained." *The American Interest.* March/April 2011.

political influence remains. Greater instability in Russia may force oligarchs to question the benefits they receive from loyalty to Putin or the likelihood of Putin's retaliation against the disloyal. Depending on how the calculus of political and financial benefit turns out, oligarchs may see opportunities to undermine Putin's power rather than seeking to support it. Deep divisions still exist within the Russian government and economy that have been obscured by Putin's central authority. If that authority weakens, the oligarchs may again shape the future of Russia. They are waiting.

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