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Putin's Plutocrat Problem

By *Lee S. Wolosky*

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FACE OFF

When Russian President Boris Yeltsin resigned on December 31 of last year, he thrust Vladimir Putin, a relative unknown, into the limelight. Today, just a few months later, it is still too early to determine the extent of the former KGB agent's commitment to democracy and free markets. But if Putin decides to match words with deeds, he will enjoy an encouraging alignment of the political stars. Unlike Yeltsin, Putin can count on the support of the public and of the Duma, Russia's lower house of parliament. He has also built bridges with rival political leaders. For a limited time at least, he can use this support to press ahead with difficult reforms.

To do so, however, he must first rein in a dangerous posse of plutocrats riding roughshod over the country. This is something his predecessor could not, or would not, achieve. On the contrary, these oligarchs -- Boris Berezovsky, Mikhail Khodorkovsky, Roman Abramovich, Mikhail Fridman, and others -- largely co-opted Yeltsin's governments, silencing most opposition to their conduct. As a consequence, they now threaten Russia's transition to democracy and free markets. They also threaten vital U.S. interests, because America's long-term security is best assured by the success of Russia's transformation.

The oligarchs dominate Russian public life through massive fraud and misappropriation, particularly in the oil sector. Oil is of overwhelming importance to Russia and the oligarchs. Prior to its collapse, the Soviet Union was the world's largest oil producer. Oil companies account for nearly 60 percent of the market capitalization of the Russian stock market, and oil receipts amount to about 22 percent of the government's budget revenues. Whoever controls this massive industry controls much of the world's oil supply -- and today it is the oligarchs.

The August 1998 financial crisis practically wiped out the plutocrats' financial assets. But those who suggest it undermined their influence are dead wrong. Oil revenues sustained the tycoons' economic and political power, and the oil oligarchs are once again awash with cash, thanks to the ruble devaluation of 1998 (which lowered costs) and the steep climb in oil prices in 1999 (which boosted revenues). Because they remain among the strongest political and economic actors in Russia -- a major nuclear power whose future is crucial to America -- the plutocrats merit close scrutiny.

MAKING IT

In 1995, a businessman named Vladimir Potanin concocted a brilliantly self-serving scheme: the financially strapped Russian government would mortgage the state's most valuable industrial assets to a few politically connected insiders for far less than fair value.

The story of how the Russian government relinquished control of its largest enterprises (almost all of them oil companies) through a rigged "loans-for-shares" program has been described elsewhere.1 In short, government shares in large enterprises were placed under trust management with oligarch-affiliated banks and financial institutions in exchange for loans to the state. When the government defaulted on these loans -- as was all but assured -- the creditor-trustees acquired the right to auction the collateral stakes. Almost invariably, the auction winners turned out to be affiliates of the banks, who paid only a nominal amount above auction starting prices. And so the oligarchs gained control of the state's most valuable assets at knock-down prices.

To fund at least part of their winning bids, the oligarchs appear to have used the government's own money. In the early and mid-1990s, "authorized" banks controlled by the plutocrats misappropriated billions of dollars from the government, either directly or through sweetheart deals involving the custody of public funds. For instance, $512 million entrusted by the Russian government to affiliates of Potanin's Uneximbank reportedly disappeared. According to a government audit, billions of dollars in federal funds entrusted to oligarch-affiliated banks for the reconstruction of Chechnya also vanished. Even when government funds held by the oligarchs' banks were paid to their intended beneficiaries, they came late and without the substantial interest earned from interim investments in short-term government debt. The enormous yield on those investments was pocketed by the banks, an arrangement presumably facilitated by kickbacks to bureaucrats or by their lack of appreciation for the time value of money.

The industrial assets bought at auction by the oligarchs were considerable and the prices paid a relative pittance. Affiliates of Khodorkovsky's Rosprom-Menatep group acquired control of the Yukos oil company for $159 million. Yukos is one of the largest oil companies in the world: last year it produced 44.5 million tons of crude oil worth approximately $8 billion at current market prices. Its proven reserves amount to 11.5 billion barrels, comparable to those of British Petroleum prior to its merger with Amoco. Meanwhile, affiliates of Berezovsky and Abramovich acquired control of Sibneft for only $100.3 million. In recent years, Sibneft has produced oil worth $3 billion annually, and its proven reserves rival Texaco's. Potanin's Interros-Neft acquired control of Sidanko, a comparably sized company, for $130 million. He later sold ten percent of it to British Petroleum for $571 million.

The oligarchs' oil assets are actually holding companies with no operating businesses of their own. Their value lies in their ownership of stakes in vast oil production companies that employ tens of thousands of people. Rather than investing in and restructuring these production companies, the oligarchs looted them -- thereby defrauding a wide range of stakeholders, including workers, pensioners, suppliers, minority shareholders, creditors, strategic partners, and local, regional, and federal governments that depend on the companies for tax revenues.

Just how does this pillage occur? Transfer pricing is one of the oligarchs' most reliable methods. The tycoons force Russia's oil production companies to sell oil to parent companies at below-market prices. A portion of that oil is then resold on world markets at the prevailing price. The oligarchs thus systematically strip value from operating companies and their stakeholders. For example, in the first nine months of 1999, Yukos forced its three partially owned subsidiaries to sell it some 240 million barrels of oil at approximately $1.70 per barrel -- at a time when the average market price was about $15. Yukos then exported nearly a quarter of that oil to world markets. And so Khodorkovsky's Yukos managed to siphon off some $800 million during a span of approximately 36 weeks.

Despite the fact that these practices are illegal under Russian law, virtually all of Russia's oil oligarchs engage in them -- with predictable results. Whole regions of Russia are being impoverished. By mid-1998, regional and local tax arrears in Nefteyugansk, where Yukos' main production company (and little else) is located, exceeded $200 million. According to Nefteyugansk's mayor, these shortfalls brought the region to "the verge of disintegration." In addition, wage arrears and drastic pay cuts for oil workers led to a "socially explosive situation." Investors, of course, are also defrauded. Minority shareholders in Yukos-controlled oil production companies include U.S. and international investors, as well as thousands of individual Russians; Yukos-controlled Tomskneft, for example, has more than 13,000 individual Russian shareholders, many of whom are workers and pensioners in the Tomsk region and each of whom holds only a handful of shares.

The massive dilution of capital has been another method of pillage. In September 1997, Sibneft (controlled by Berezovsky and Abramovich) engineered the issuance of more than 44 million new shares of its principal production company, Noyabrskneftegaz, at a below-market price. Those shares were sold to affiliates of Sibneft, who then transferred them to the parent company itself. The transaction diluted the equity of existing Noyabrsk stockholders by 75 percent. Because the stock was sold below market price, the transaction also resulted in the transfer of over $400 million in value. And Berezovsky and Abramovich later used their new supermajority voting power to merge Noyabrsk out of existence.

Not to be outdone, last year Khodorkovsky tried to defraud both creditors and minority shareholders through shady offshore transactions. After three international banks acquired approximately 30 percent of Yukos following a default on a loan to an affiliated bank, Khodorkovsky sought to turn Yukos into an empty shell. He forced it to convey its most significant asset -- its controlling position in oil production subsidiaries -- to unknown offshore entities. At the same time, he attempted the mother of all share dilutions: by transferring a massive number of new shares to offshore entities he is believed to control, Khodorkovsky sought to water down shareholder stakes in Yukos' oil production companies by as much as 240 percent. And despite injunctions in places ranging from the British Virgin Islands to the Isle of Man, Khodorkovsky is still moving forward with the transactions.

But the pillage does not stop there. The oligarchs loot their companies even more directly -- by stealing valuable assets, including wells, equipment, and anything else that can be found on an oil field. Over the past two years, Yukos has forced its subsidiaries to transfer substantial assets to new companies -- notwithstanding a conflicting February 1998 order by the Russian Federal Securities Commission. In fact, from 1997 to 1998, Yukos made the oil production companies it controls part with assets having a book value of some $3.5 billion.

The victims have not been limited to bit players; asset-stripping has also victimized major international oil companies. In a highly publicized case, Fridman's Tyumen Oil Company (TNK) allegedly stole Sidanko's most valuable assets by manipulatinig the bankruptcy process. According to defrauded Sidanko shareholders (who include BP Amoco), the theft was carried out through the corrupt appointment of a TNK-friendly receiver, the unlawful reduction of the claims of major creditors such as the European Bank for Reconstruction and Development (in which the United States holds shares), and a rigged bankruptcy "auction" in which only TNK-affiliated companies could bid.

This was not BP Amoco's first run-in with the oligarchs. In 1993, Amoco, in a joint venture with Yuganskneftegaz, won an international tender for half of the massive Priobskoye oil field -- the largest undeveloped field in Russia. After Khodorkovsky gained control of Yuganskneftegaz in 1995, he offered Amoco new terms: more money for a smaller stake. When Amoco referred to the signed contract in protest, Khodorkovsky reportedly only smirked -- and then kicked Amoco out of the Priobskoye project altogether, notwithstanding four years of work and an investment of at least $100 million.

TOUGH LOVE

Putin's support for the early ratification of START II and for other arms control initiatives is commendable. But absent unilateral Russian disarmament, America's security would best be assured by Russia's transition to a democratic, market-oriented, and law-based state. To the extent that the oligarchs jeopardize that transition, they threaten more than the triumph of American values. They threaten the vital American interest in assuring dependable stewardship of Russia's vast nuclear arsenal. The oligarchs also threaten the security of the West's oil supply. The dangers they pose have economic, political, and strategic dimensions -- and so too must the American response.

The oligarchs' malfeasance has deprived Russia of the private investment it needs to complete its economic transition. Russia needs capital -- far more than is available from public sources. According to Anatoly Chubais, the principal architect of Russia's privatization program, Russia needs hundreds of billions of dollars for industrial restructuring and modernization. Yet private investors have abandoned the country because, among other things, their legal and economic rights are abused there with consistency and impunity.

Investor fear has a ripple effect not limited to the oligarchs' own enterprises. Widely publicized misconduct involving Russia's largest companies and most prominent business leaders scares away international investors from all Russian companies -- including those with no intention of defrauding anyone. The problem is compounded by staggering capital flight, which removes further funds from the cash pool available for investment in Russian industry. In recent years, Russia has received less direct investment than has Peru. At the beginning of 1999, daily trading volumes on the Russian stock market were less than $1 million and have since risen to only $15-20 million. The total market capitalization of all companies listed on the Russian stock exchange is approximately $36 billion. By contrast, the market capitalization of Yahoo alone exceeds $90 billion. Russia's economy will never evolve into anything resembling a normal market economy at such levels of investment.

The effect of the oligarchs' conduct on private investment also raises fundamental questions about international lending programs to Russia. Few would dispute that support from international financial institutions should not be extended to any country indefinitely. Instead, public moneys should be provided to overcome short-term liquidity crises -- but only until they can be supplanted by more significant private capital. Yet Russia, thanks in large part to the oligarchs, is not a likely candidate for the early return of private capital -- from either Russian or international sources.

To account for this reality, Western leaders should rethink the conditions they attach to credits given to Russia by institutions such as the International Monetary Fund or the World Bank. Contrary to the proposals of certain European leaders and U.S. presidential candidates, conditions should not be narrowly tied to events in Chechnya, where the United States lacks vital interests, but to developments in Russia as a whole, where America has a range of such interests. Second, conditions should be designed to help create the kind of environment necessary for the return of private capital. Although current and potential investors in Russia value macroeconomic stability and responsible fiscal policies, they frequently have more basic concerns, such as how to protect their investments from outright theft. Public lending should be conditioned on building the institutions of government necessary to prevent such larceny. Deep structural and institutional reform will be strongly resisted by the oligarchs, but it is necessary nonetheless. Without it, public moneys will be wasted, and Russia will become a permanent beneficiary of international welfare.

REINVENTING GOVERNMENT

The recent unwillingness or inability of Russia's senior leadership to curtail the oligarchs' predation raises serious questions not only about the prospects for the development of free markets and the rule of law, but about Russian democracy itself. After the last presidential election, in 1996, the oligarchs captured Yeltsin, his successive governments, and the political process. Regrettably, few signs so far point to significant changes under Putin.

In October 1999 -- after Putin had already become prime minister -- Russia's chief market regulator, the reformer Dmitri Vasiliev, resigned in protest over his inability to stop Yukos' fraudulent offshore share transactions. Vasiliev had earlier requested a criminal investigation of the deals, the third inquiry into Yukos requested or begun by Vasiliev's Federal Securities Commission since February 1998. Uncooperative government agencies and a corrupt Russian judiciary, however, thwarted Vasiliev's efforts. An interagency investigation initiated by Vice Premier Vladimir Bulgak in March 1999 met a similar fate.

These failures are hardly surprising. The oligarchs enjoy enormous political power, derived from their money, media control, and direct and indirect participation in decision-making at many levels of government. Russia's energy oligarchs have invested wisely; they provided Yeltsin's 1996 presidential campaign with unlimited financial support, which enabled him to wrest victory from Communist Party leader Gennady Zyuganov. And the oligarchs were amply rewarded for their generosity. Both Potanin and Berezovsky served in high government office, Potanin as first deputy prime minister and Berezovsky as deputy secretary of the National Security Council and then as secretary of the Commonwealth of Independent States. Fellow energy baron and former Gazprom head Viktor Chernomyrdin led the government as prime minister from 1992 through 1998. (Gazprom, the huge gas monopoly, is Russia's largest company.) Chernomyrdin is widely rumored to be one of Gazprom's largest shareholders and Russia's richest citizens.

Even after Chernomyrdin's ouster, the oil oligarchs' privileged access to power continued. Berezovsky and Abramovich allegedly handled Yeltsin family finances. Khodorkovsky routinely traveled with the prime minister -- whoever that happened to be. He was reportedly aboard Yevgeny Primakov's plane to Washington in March 1999 when it reversed course in midair to protest the NATO bombing of Kosovo. And in September 1999, he accompanied then-Prime Minister Putin to New Zealand for an economic summit.

When not serving personally as high government officials or whispering in the ears of those who are, the oil oligarchs protect their interests through highly placed proxies. Khodorkovsky's man, former Yukos senior official Sergei Generalov, served as minister of fuel and energy from 1998 to 1999. Berezovsky's agent, Nikolai Aksenenko, was until recently the first deputy prime minister. Another Berezovsky proxy, Alexander Voloshin, is head of the presidential administration. And Voloshin's top deputies include two men from the financial interests controlling TNK.

The loyalty of lesser officials is routinely secured through bribes, kickbacks, and "charitable contributions." A favorite scheme involves buying the allegiance of law-enforcement officers by donating motor vehicles. An investigation of Yukos in Moscow, for example, was complicated after Yukos promised to buy cars for the Federal Security Service. Similarly, Sibneft has reportedly donated 50 Land Rovers to the Omsk police.

Sometimes payoffs are even more direct. In Moscow, $50,000 can stall a criminal investigation. The Russian judiciary faces similar temptations. In cases involving the oligarchs, trial and appellate court judges are routinely bribed. Failing that, judges who evince a dangerous predisposition to impartiality are reassigned without explanation by superiors who are presumably on the take.

The pervasive political influence of Russia's oil oligarchs shows no likelihood of rapid abatement. Putin has not swept house at the Kremlin. On the contrary, one of his first official acts was to reappoint Voloshin head of the presidential administration. Voloshin, in cahoots with Berezovsky, has been accused by former Soviet President Mikhail Gorbachev of helping orchestrate Yeltsin's removal.

Oligarch money has infused all of Russia's major political movements, even the relatively incorruptible, pro-Western, reformist Yabloko bloc. In addition to funding Russia's major political parties, the oil oligarchs offered their own hand-selected candidates during the recent parliamentary elections. Some even stood for election themselves. Yukos' Generalov secured a Duma seat. Berezovsky, who is widely credited with helping mastermind the meteoric rise of the pro-Kremlin Unity Party, won a seat representing a district in Karachay-Cherkessia, and Abramovitch was elected for the remote Chukotski Peninsula.

To be sure, big business interests infuse the political systems of many countries, including the United States. But in Russia, the political influence of the oligarchs is largely the fruit of criminal activity. It is also amplified by several factors unique to that country. One, as Russia scholar Michael McFaul has noted, is the weak party system. Russia lacks true political parties. What it has instead are loose, poorly organized coalitions centered around one or two strong personalities. This lack of a real party system inhibits conflict resolution among competing interest groups. Compounding matters, civil society is woefully underdeveloped. Institutions and interest groups that could potentially countervail the influence of the oligarchs are weak. Labor is disorganized; small business is virtually nonexistent; civic organizations are confused and dispirited.

Significantly, Russia also lacks a free press -- not because of government censorship but because of oligarch control of the most meaningful media outlets. Berezovsky controls the ort television station; TV-6; the newspapers Nezavisimaya Gazeta, Novaya Izvestiya, and Kommersant; and Ogonek magazine. Potanin controls the newspapers Izvestiya, Komsomolets, and Russki Telegraf and Ekspert magazine. Until recently, a Khodorkovsky lackey even served as deputy head of ITAR-TASS, the state news agency.

That Russia lacks independent institutions, interest groups, or news media to counter the oligarchs is hardly surprising. The tycoons' predation has sucked up the country's wealth and impoverished broad swaths of Russian society. A basic gauge of income inequality, the Gini coefficient, has doubled in recent years. Financial theft has deprived ordinary people and governments at several levels of their fair share of the fruits of Russian industrial activity. All this prevents the diffusion of social, political, and economic power within Russia and runs counter to vital U.S. interests in promoting Russian democratization.

The financial power of the oligarchs is changing political dynamics in Russia in other, less obvious ways. For one, it is hastening centrifugal tendencies within the country. As in communist days, economic value continues to be siphoned from Russia's regions to the center and returned to the regions in the form of various transfer payments. Now, however, the recipients of Russia's wealth and the distributors of largesse are increasingly Moscow-based financial elites, not the Kremlin. This marginalizes the Kremlin's political influence in Russia's restless regions.

The oligarchs' control over local purse strings manifests itself in their patronage of social infrastructure and haphazard tax payments to local and regional authorities. The infrastructure attached to an oligarch-controlled enterprise may include schools, hospitals, and recreation facilities; such "social assets," a relic of communism, still play an important role in many communities built around industrial enterprises. Support for social infrastructure buys the oil barons considerable local influence.

More significant, local and regional tax payments are no longer based on objective criteria. Instead, they are negotiated between plutocrat and governor, many of whom lack the power to discipline recalcitrant oligarchs.

A similar situation exists at the federal level. The fact that tax payments by Russia's energy tycoons, when made at all, are negotiated affairs is testimony to the oligarchs' power and the weakness of the state. These arrangements threaten more than the development of Russian democracy. They undermine the very integrity of the Russian Federation.

GET PERSONAL

Even accounting for a precipitous drop of almost 50 percent in the past ten years, Russia still produces more oil than any country in the world except the United States and Saudi Arabia. Yet control over Russian production now lies firmly in the hands of rogues, plutocrats with greater productive assets than the largest Latin American drug cartels. The largest Russian oil companies today are little more than semicriminal groups that defy international standards of lawful conduct. Certain oil oligarchs or their close associates are currently under investigation by U.S. and European law-enforcement officials for money laundering, corruption, and fraud.

The oligarchs' criminality therefore threatens more than the security of the world's energy supplies; to the extent that it leaks out of Russia, it also challenges the West's commitment to the international rule of law.

At issue are not simply cases of financial impropriety. The oil oligarchs are extremely ruthless. People who get in their way -- even ministers of the Russian Federation -- are routinely threatened. A senior TNK official involved in the Sidanko-BP Amoco dispute allegedly waved a pistol in the face of the mayor of Nizhnevartovsk. A local judge who had made a decision adverse to TNK was reportedly beaten in the street. In June 1998, the mayor of Nefteyugansk was murdered. That spring, he had led a very public crusade and hunger strike against Yukos, protesting the enormous wage and tax arrears that he claimed were impoverishing the region. A rowdy public protest was held outside a shareholders' meeting, trapping Yukos' president inside for several hours. The mayor had previously sent a secret cable to Prime Minister Sergei Kiriyenko requesting his assistance in the showdown. But the mayor was found dead before Kiriyenko could answer.

Elsewhere, in March 1999, the car of a Russian oil executive allied with Western investors against Yukos was attacked in a military-style ambush. The executive was not in the car at the time of this attempt on his life -- the second such attack. His bodyguards and driver were not as fortunate, however: one was killed in the assault, the others badly wounded. A similar fate awaited the general director of the Omsk oil refinery, the largest in Russia. The month before Sibneft came into existence, he was found floating in a river. He was said to have opposed the planned handover of his refinery to Sibneft. In September 1995, the man who handled most of Noyabrysk's crude exports was luckier. He was thrown in jail and released months later without being formally charged.

In the face of such venality, what is the West to do? Apart from changing its approach to public-sector lending, it must get personal. Russia's oil oligarchs should be treated like pariahs. They should be denied access to international capital for the companies they control. They must get no support from federal agencies such as the U.S. Export-Import Bank. To contain Russian crime and corruption, U.S. and Western law enforcement agencies should vigorously prosecute cases in their jurisdiction. That will help ensure that money misappropriated from Russia is returned to Russia. It will also prevent the West from becoming a safe haven for overseas criminality and will uphold America's commitment to the rule of law. Not only should Washington, Wall Street, and London refuse the oligarchs the respectful receptions and prestigious platforms they crave for self-legitimization, but certain of the oligarchs should be denied visas to visit the West for any purpose.

Pariah status should continue until the oligarchs modify their behavior -- or until Putin renationalizes that country's rogue oil companies. Given the extraordinary circumstances and the considerable stakes, the United States and multilateral organizations should actively encourage and support renationalization and reprivatization on a case-by-case basis. In the battle against the oligarchs, Moscow and the West must rely on every weapon available. If they do not, the oligarchs will.

1 See, for example, Ira W. Lieberman and Rogi Veimetra, "The Rush for State Shares in the 'Klondyke' of Wild East Capitalism: Loans-for-Shares Transactions in Russia," George Washington Journal of International Law and Economics, vol. 29, no. 3, 1996, p. 773.

G.T · a year ago

This article, though now over a decade old, should be read by all those still attempting to claim that Khordorvsky's sentence was unjust.

2 • Reply • Share ›

Guest · 7 months ago

I new in general the oligarchs had raped the nationalized companies. But I had never understood the extent of it, and how they did it. My my. It changes my entire view of Abramovich's yacht. All I see now is criminal wealth, where as before I was impressed. Putin obtained his billions in a similar fashion. I guess he couldn't resist the temptation. It sheds new light on the hatred of the oligarchs in the Ukraine as well. This essay explains a lot of what's going on today. It dials things a little more clearly.

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