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The Oligarchy: 1996–98

At the turn of 1995, Russia underwent a quiet but distinct change. The state enterprise managers lost out to younger big businessmen, who were known as oligarchs.[1]

The old managers failed for many reasons. They did not know how to run their companies under the new market conditions. Output continued to fall, and many of them were able to adjust only by cutting costs. They ran up notorious wage and interenterprise arrears. The ample rents of 1992 and 1993 had abated, and direct budgetary subsidies were insufficient to keep the managers afloat. Most of them knew little about finance and they were contemptuous of marketing. They failed to keep up with the changing nature of rent seeking. Insider privatization had given them ownership control over their companies, but mostly through minority posts. Gradually, one after the other, these substandard managers were ousted by outside raiders, exactly as the privatizers had hoped.

The rookies who rose to the apex of economic power were as colorful as the managers were gray. They were the first products of transition, and Russians received the oligarchs with awe and fascination. Their outstanding talent was financial magic: to make money out of anything, by any means, and they changed their techniques of enrichment almost as often as their beautiful women changed clothes. They made money on stocks and bonds and of course also on the state rather than on production. The old managers were no paragons of virtue, but the oligarchs were the

1. This period has received the best coverage in the literature because Russia was more open than ever before and the drama was fascinating. Excellent journalistic books are Brady (1999), Freeland (2000), Klebnikov (2000), and Hoffman (2002). A scholarly Russian book, Pappe (2000), adds facts and structure.

paragons of vice. Their only criterion of success was profit. A wave of jokes swept across the country about the "new Russians," who boasted about their expensive habits. The oligarchs bought old palaces in Moscow and restored them to a splendor greater than in the days of the tsars. In a few years, the patently gray Soviet Moscow turned into a colorful city of casinos and wild nightlife.

Who were these spectacular oligarchs and how did they attain their summit? Their rise was gradual, but the loans-for-shares privatizations in late 1995 signified their arrival. In the presidential elections of June–July 1996, Yeltsin won with the joint support of reformers and oligarchs. After Yeltsin had defeated the revitalized communist challenge, the reformers hoped for a new reform wave, but the dawn of new reforms turned out to be false because the oligarchs and reformers did not share interests in economic policy. Instead, "the bankers' war" erupted in the summer of 1997, and the acrimony between reformers and oligarchs contributed to the financial crash in August 1998. In conclusion, the oligarchs are assessed.

Who Were the Oligarchs?

The oligarchs were everything that the Soviet Union was not. They were fast and innovative, unconventional and conspicuous. They were the ultimate opportunists prepared to do whatever it took to become truly wealthy. The sky was no limit for these men. The only thing they had in common with the Soviet system was the contempt of law.

"Oligarch" is an ancient Greek concept, and an "oligarchy" is defined as "government in the hands of a few." In Russia, "oligarch" became a popular label for big businessmen around 1994 when the first truly rich people emerged, meaning a very wealthy and politically well-connected businessman, a dollar billionaire, or nearly so, who was the main owner of a conglomerate of enterprises and had close ties with the president. It would be more appropriate to call them plutocrats, because they focused on making money rather than ruling the state, and they did not maintain steady alliances, but the term "oligarch" stuck. Since the mid-1990s, the oligarchs have been a fixture on the Russian stage, but their personalities and activities have changed more than anybody seems to realize.

In October 1996, one oligarch, Boris Berezovsky, boasted that he was one of seven oligarchs who had been meeting weekly since February 1996. They maintained close contacts with the president's office, and they owned half of Russia (Freeland et al. 1996). The other six oligarchs were Mikhail Khodorkovsky, who controlled Bank Menatep; Aleksandr Smolensky, with Stolichny Bank; Mikhail Fridman and Petr Aven, with Alfa Bank; Vladimir Potanin, with Oneximbank; and Vladimir Gusinsky, with Most Bank and a media empire, including the independent television channel NTV.

In terms of business, Berezovsky was the odd man out, because his main company was Russia's biggest car dealership, Logovaz, whereas the other oligarchs were bankers. Berezovsky had only a minor bank (Obyedinnyony), and he was a minority shareholder in Smolensky's Stolichny Bank. Berezovsky's specialty was to tap the cash flow of state enterprises, such as the car company Avtovaz, the dominant state TV channel ORT, and Aeroflot. He was more of a courtier and financial operator than an entrepreneur. Moscow talked about *semibankirshchina*, the rule of seven bankers, but that was a gross exaggeration, as was Berezovsky's claim about their wealth. It would be more appropriate to talk about a dozen oligarchs, including Vladimir Vinogradov of Inkombank, Vitaly Malkin of Rossiisky Kredit, and Vagit Alekperov of Lukoil.

Something had happened to Russian business. Virtually all these early oligarchs were bankers, and their rise signified the defeat of the industrialists by the bankers. They were all Muscovites, because the financial sector was concentrated in Moscow. Russians noticed that all but one (Potanin) of the seven bankers were Jewish. Some were very young—in their early 30s. All had higher education from Moscow's best universities, and most came from intellectual families. Only Potanin belonged to the old *nomenklatura* as a hereditary foreign trade official.

All the oligarchs were impressive personalities. They were very sociable people, because networking was their *métier*. They could penetrate any locked door. Aven, who had been minister for foreign trade in Yegor Gaidar's government in 1991–92, knew everybody worth knowing. Their actions took as much courage as ingenuity. According to an unconfirmed story, Aven and the then-unknown oil trader Roman Abramovich met for the first time at the White House on October 3, 1993. Each arrived independently on their own initiative with a suitcase full of cash, which they dished out to the special forces to convince them to fight for Yeltsin, promising them as much after the job was done. The Yeltsin family was apparently so moved that they made Abramovich, their new acquaintance, family treasurer, although he was an unknown oil trader and an orphan from a small town in the Urals.

Nobody was more busy-bodied than Berezovsky. He made friends with everybody who was useful and provided them with whatever they needed. Early friends were Yeltsin's bodyguard Aleksandr Korzhakov and Yeltsin's daughter Tatyana Dyachenko, to whom Berezovsky gave a Niva, a Russian jeep, in 1994 and later a Chevrolet Blazer. He got close to the president when he published Yeltsin's memoirs in 1994, which generated amazing revenues. In 1997, when Berezovsky controlled Aeroflot, he hired Valery Okulov, one of Yeltsin's sons-in-law, as CEO. Yeltsin's other son-in-law, Leonid Dyachenko, was an oil trader working with Berezovsky's partner Abramovich (Klebnikov 2000, 117–18, 178, 201). All these actions were completely legal.

As a foreign trade official, Potanin managed to privatize one of the old banks from the Soviet-era Council for Mutual Economic Assistance (Comecon) in some mysterious way that seemed not to require any capital, which made him an oligarch overnight in 1993. Most of the oligarchs had a team of close partners with whom they shared their wealth, but usually their decision making was as centralized as it was fast. Whatever one may think of these men's morals, their ingenuity, imagination, speed, and charisma were second to none.

Vagit Alekperov of Lukoil was different. He was no banker but he was determined to become Russia's John D. Rockefeller. In late 1995, he stated: "We want to make Lukoil into the biggest oil company in the world—in both production and profits," making clear that he intended to overtake Exxon (quoted in Klebnikov 2000, 192). In 1990, he had risen through the ranks to become deputy Soviet minister of fuel and energy at the age of 40. After the August coup he became acting minister. He utilized this opportunity to seize some of Russia's finest oil properties and incorporated them as Lukoil. In 1994, Lukoil participated in the voucher auctions and later in several small cash auctions, enabling Alekperov and his partners to accumulate 28 percent of the shares. This was an uncommon model, because most oligarchs claimed nearly full ownership, but Alekperov was older and closer to the old establishment than most of the other oligarchs and therefore more cautious.

The bankers surged with the stabilization in the spring of 1995, because the new bonanza was to buy treasury bills (known as GKO in Russian). Their real yield hovered around 100 percent a year until 1998. The bankers were not interested in inflation as the industrialists had been, but they favored a large budget deficit that maintained the government's hunger for credits and kept the real interest rates high (Treisman 1998). They also made money as "authorized banks," handling the accounts of state agencies that did not claim adequate interest for their deposits.

The oligarchs were products of the prevailing conditions, which changed at an infuriating speed. Most of them had set up early cooperatives in 1988, doing all kinds of trading. Some had taken off with the importation of computers from the West, and most of them had become millionaires by exporting oil. Next, they entered banking. They usually established new banks and attracted some capital from old state banks. Invariably, they benefited from cheap credits from the Central Bank of Russia. Only to a very limited extent did they engage in the spontaneous privatizations before 1993. In the early 1990s, successful businessmen traded and "sat on the pipe," tapping the cash flow of state enterprises rather than managing or owning companies.

They all used the Marxist concept of "primary accumulation of capital." To them it meant that anything was allowed. The law was at best relative. One of the oligarchs told me in 1999: "There are three kinds of businessmen in Russia. One group is murderers. Another group steals from other private individuals. And then you have honest businessmen like us who only steal from the state."

Everything changed with privatization. The budding oligarchs were pioneers who bought hundreds of thousands of privatization vouchers that they used at voucher auctions to buy whatever stocks they could get. At this stage, it would have been foolish to have a strategy. It was difficult enough to keep up with when and where voucher auctions were held, how much would be sold, and at what price. Small bands of treasure hunters chased good stocks all over the country. By necessity, stock prices were ludicrously low at the voucher auctions. After the auctions were completed in 1995, the new enterprise owners looked at their catch and started considering business strategy. Conspicuously, Bank Menatep ended up with control over 200 sundry industrial companies. Not knowing what to do, Menatep established a holding company, which the Menatep owners with characteristic self-confidence named Rosprom (Russian industry).

The Loans-for-Shares Privatization

The voucher privatization had been completed in 1994, but a large share of the Russian economy remained in state hands, notably, some of the country's most valuable companies. The big state-owned corporations were frightfully mismanaged and criminalized, because the incumbent managers were stealing their companies bare. In some companies a few hundred million dollars a year were siphoned off.

For political reasons, the state was compelled to move toward cash auctions, but Russians had so little money. Russia had returned to its initial dilemma—too many enterprises to sell and too little demand backed by real money. Yet it was politically impossible to sell many of these enterprises to foreigners (Kokh 1998, Chubais 1999). The government's fiscal deficit remained a serious concern, and privatization was increasingly seen as a fiscal solution.

Potanin took the initiative in 1995. He proposed a debt-for-equity swap. He formed the Consortium of Russian Commercial Banks, which included six leading oligarchic banks. They offered to lend the cash-strapped Russian government $2 billion for one year against a collateral of big stakes in some of the country's best companies. The banks would manage the companies in trust, and if the state did not repay the credits one year later, the bankers would be entitled to sell their collateral, also to themselves. The proclaimed intention was that they would compete in auctions about offering the largest credit for each company. Yeltsin signed the decisive decree on August 31, 1995, and the auctions took place during November–December 1995 (Kokh 1998, 104; Klebnikov 2000, 198).

I discussed the impending loans-for-shares auctions with Chubais in September 1995. His primary goal was to continue privatization, and this was the only possible option. He was anxious to replace the criminal state managers who blocked all progress and he held great hopes for Russia's new big businessmen. However, he had been forced to make two concessions: These auctions were not open to foreigners, and the prices would by necessity be very low. He reassured me that the auctions would be open to Russian competitors, but that did not work out either.

Originally, the bankers proposed 43 lucrative corporations for privatization, but most of them resisted ferociously. Eventually, 16 companies were put up for auction, of which four attracted no bid. The 12 companies sold included five oil companies (Yukos, Sibneft, Sidanko, Lukoil, and Surgutneftegaz), Norilsk Nickel, two steel corporations (Novolipetsk and Mechel), two shipping companies, and the oil-products trader Nafta Moskva (Kokh 1998, 108–10).

Several of these auctions did not change control. The managers of Lukoil and Surgutneftegaz used this opportunity to expand their ownership. In reality, only three companies were controversial—Yukos, Norilsk Nickel, and Sibneft (Kokh 1998, 115–30)—and all the writing about the loans-for-shares auctions discusses these three corporations. Oneximbank bought Norilsk Nickel for $170 million. Menatep acquired 86 percent of Yukos' shares for $309 million. Berezovsky and the new oligarch, Abramovich, bought a majority of Sibneft for $100 million (Kokh 1998, 121, 123, 126; Freeland 2000; Hoffman 2002).

These sales aroused sharp criticism from the outset. As usual, the oligarchic banks were divided. Oneximbank, Menatep, and Stolichny were on the inside, being challenged by Rossiisky Kredit, Inkombank, and Alfa Bank on the outside. The banks that bought these companies organized the auctions themselves. Russian competitors offered higher bids, but they were disqualified with the argument that they could not pay as much as they promised. The rivals were powerful and discredited the winners. Many Russian reformers parted with Chubais over these auctions. Western organizations that had participated in prior Russian privatizations stood aside and took exception, and the Russian reformers lost their luster in the West. Naturally, the communists and nationalists in the Duma seized upon these controversial privatizations. The communists set up a special Committee to Investigate Privatization and Punish the Guilty (Blasi, Kroumova, and Kruse 1997, 75).

Part of the problem was that these privatizations were actually the most transparent Russian privatizations, and everybody could see all the details. Nobody knew who had bought how many shares at what price in insider privatized companies such as Lukoil and Surgutneftegaz, which rendered them much less controversial. Forty percent of Gazprom had been sold for $100 million, as much as Sibneft, although that share of Gazprom was worth about 10 times more than Sibneft (Klebnikov 2000, 135). But unlike the taciturn Viktor Chernomyrdin, the ostentatious and demonstrative Berezovsky could not keep quiet about his wealth.

The loans-for-shares privatizations were qualitatively important, because they marked the demise of the state enterprise managers and the rise of the oligarchs. As Chrystia Freeland (2000, 170) pointed out: "Loans-for-shares was revolutionary because it…took companies away from their red directors and gave them to a handful of thrusting entrepreneurs."

The incumbent managers resisted this privatization, and they were ousted in short order by the oligarchs. Vladimir Bogdanov of Surgutneftegaz realized that the oligarchs were too strong to be beaten, so he joined them, letting Surgut's pension fund purchase 40 percent of the company for a mere $88 million. Bogdanov was the presumed real owner, and he became recognized as an oligarch. Alekperov of Lukoil, who had the habit, as the Russian saying goes, to dance at every wedding, did not get too deeply involved in this scheme, but he picked up another 5 percent of his company (Freeland 2000, 178; Klebnikov 2000, 209).

This privatization formed a new political alliance between reformers and oligarchs: "At heart, the loans-for-shares deal was a crude trade of property for political support. In exchange for some of Russia's most valuable companies, a group of businessmen—the oligarchs—threw their political muscle behind the Kremlin" (Freeland 2000, 169).

The oligarchs were neither liberals nor reformers. They had made their money on rent seeking, opportunism, and ruthlessness. An underlying rationale in the loans-for-shares scheme was that the oligarchs would hold the enterprises in trust for one year. Only after the presidential elections in mid-1996 would the oligarchs be allowed to buy the shares. These privatizations were a tool to ally the quixotic oligarchs with Yeltsin in the upcoming presidential elections (Freeland 2000, 180–81).

The government's defense was that the loans-for-shares auctions generated state revenues of more than $1 billion. No other privatization had generated such large state revenues. Potanin refuted complaints that he had bought Norilsk Nickel too cheaply: "And how much does a firm cost on the market with guaranteed losses, billions of dollars in fixed capital and sales, but with many years of negative cash flow of several tens of millions of dollars?" (quoted in Pappe 2000, 21). Khodorkovsky told Chrystia Freeland (2000, 178): "These were companies that the government was simply unable to sell," because they "were run by very powerful directors."

Initially, the oligarchs had to struggle to gain control over their new assets because the old managers did not give them up voluntarily. Many stocks were dispersed and it took some time to consolidate ownership. The oligarchs did so partly by diluting minority owners' holdings and partly by continuing to tunnel profits out of the companies through transfer pricing. But by 1999 a remarkable recovery started, recorded by Andrei Shleifer and Daniel Treisman: "Between 1996 and 2001, the reported pretax profits of Yukos, Sibneft, and Norilsk Nickel rose in real terms by 36, 10, and 5 times, respectively" (Shleifer 2005, 167). The stock market valuation of Yukos and Sibneft surged more than 30 times in real terms. Contrary to frequent allegations that the oligarchs indulged in asset stripping (Goldman 2003, Stiglitz 2002), their assets increased sharply after 1999. Yukos' assets trebled from 1998 to 2002, while asset stripping proceeded at Gazprom (Shleifer 2005, 167–68). Yukos and Sibneft led the spectacular recovery of Russia's oil production. By 2000, Yukos paid $6 billion a year in taxes,[2] which is more than it would have cost if the company had been auctioned internationally in 1995. At a maximum, Yukos could have caught a price of $5 billion, which was the market value of the Menatep stake in August 1997 after the stock market had quintupled (Klebnikov 2000, 209).

The oligarchs had been accused of lacking industrial knowledge, but they brought in the needed skills. They used international auditing companies to sort out the finances. They hired the American oil service companies Schlumberger and Halliburton to improve the poor exploitation techniques in the Russian oil fields. International management consultants helped them to rationalize their companies. To combat criminality, the oligarchs deployed their own security forces. However, success was never a given: the oil company Sidanko went bankrupt, underlining the commercial risks involved.

A decade after the loans-for-shares privatizations, it is difficult to understand the great emotions they aroused. After all, only three significant companies changed management and all became stunning successes of industrial restructuring. Conversely, only three prominent oligarchic groups benefited, and the loans-for-shares scheme did not make them oligarchs because they were already known as such. All the oligarchic banks involved have actually gone bankrupt and vanished. The Russian privatization scheme was never designed to be moral or egalitarian but to be functional, to privatize and generate able owners. The loans-for-shares did exactly that. Hardly any privatization scheme in world history can record such great economic success.

The loans-for-shares privatizations marked a divide. Private enterprise had already shown its superiority over state ownership. Now, the new oligarchs took over from the state enterprise managers. Chubais and his reformers had lost their political virginity in the eyes of the West and Russian liberals. The stage had been set for the presidential elections in 1996. The oligarchs and the reformers would unite against the communists, but the communists would campaign more intensely than ever against privatization.

The 1996 Presidential Elections: Oligarchs and Reformers United

The Russian government looked miserable in the winter of 1995–96. It was failing both in the war in Chechnya and in the battle for economic re-

2. See www.yukos.com (accessed on December 15, 2005).

Table 5.1 Results of election to the State Duma, December 17, 1995

Party	Percent of votes
Communist Party of the Russian Federation	22.7
Liberal Democratic Party of Russia	11.4
Our Home Is Russia	10.3
Yabloko	7.0
Others or against all	48.5
Voter turnout	64.4

Source: Colton (2000, 36, 232).

vival. The loans-for-shares privatizations were seen as corrupt. The regime looked all the worse because Gusinsky's NTV criticized the war in Chechnya and the economic policy every evening in excellent analytical television programs. Yeltsin was physically ailing and was rarely seen. In January 1996, his poll rating hit a low of 3 percent.

The first test of the government was the State Duma elections on December 17, 1995. Chernomyrdin, who had benefited from not standing in the elections in December 1993, made the mistake of heading a new government party, Our Home Is Russia (which was appropriately nicknamed "Our Home is Gazprom"). The assumption was that it would win the Duma elections, making Chernomyrdin a plausible candidate to replace Yeltsin in the presidential elections scheduled for June 1996.

If the election results in December 1993 had been a shock, the election results in December 1995 were devastating. None other than the old, unreformed Communist Party came roaring back, winning 22.7 percent of the votes cast, Vladimir Zhirinovsky's misnamed Liberal Democratic Party of Russia (LDPR) obtained 11.4 percent, and Chernomyrdin's Our Home Is Russia came third with merely 10.3 percent. Only one more party passed the 5-percent hurdle for representation, namely Grigori Yavlinsky's liberal opposition Yabloko Party with 7.0 percent. Gaidar's Russia's Democratic Choice did not even cross the threshold for representation, but neither did many socialist and nationalist parties. Russia's Duma had a solid red-brown majority for the next four years (table 5.1; Colton 2000, 232).

Chernomyrdin remained prime minister, but he was demoralized. The election results showed that he could not win a presidential election. Rather than blaming Chernomyrdin, Yeltsin sacked his most loyal servant Chubais as first deputy prime minister, insulting him publicly with the much-quoted words: "Chubais is guilty for everything." Especially, he blamed Chubais for "grave mistakes in privatization" (Freeland 2000, 192). For the first time since November 1991, Chubais was outside the government, which no longer contained any major reformer.

The implausible favorite to become Russia's next president was Gennady Zyuganov, an unreconstructed communist and ardent Russian nationalist. In January 1996, his poll rating was already 20 percent. As a former mid-level party official, he had surged when more able communists had been ousted or resigned. No viable alternative to Yeltsin had emerged, and however ill he seemed in January 1996 his advisors agreed that he was the only viable candidate. The reformers were reluctant to support Yeltsin because of the war in Chechnya. Eventually, the Gaidar team supported him, while the always oppositional Yavlinsky insisted on standing in the presidential election.

After Chernomyrdin took a political back seat, Soskovets became the government's political leader. Together with Yeltsin's bodyguard Korzhakov and Mikhail Barsukov, chairman of the FSB, he set up Yeltsin's official campaign staff. But these old-fashioned, Soviet-style bureaucrats knew neither how a democracy worked nor how to organize an election campaign. They stood for nothing but power. Their idea of an election campaign was to order senior officials to command their subordinates to vote for the ruler (Klebnikov 2000, 216).

Several of the oligarchs, as well as Chubais, attended the World Economic Forum in Davos, Switzerland, in early February 1996. The oligarchs were truly frightened by Zyuganov's forceful appearance, and they were impressed by Chubais, because of his sharp attack on Zyuganov: "If Zyuganov wins the Russian presidency in June, he will undo several years of privatization and this will lead to bloodshed and all-out civil war" (quoted in Freeland 2000, 193). The oligarchs worried about their newly won property and decided to unite behind Yeltsin. They chose Chubais as their secret campaign manager, running an alternative Yeltsin campaign. The loans-for-shares construction had worked. From February 1996, the leading oligarchs started meeting regularly, and Yeltsin's daughter Tatyana Dyachenko became their liaison with Yeltsin (Freeland 2000, 195).

On February 15, Yeltsin went to his hometown Sverdlovsk/Yekaterinburg to announce that he would run for reelection. At first, nobody took his candidacy seriously. It seemed just embarrassing. But the old Yeltsin, the vote-getter and fighter, had woken up. Amazingly, this infirm man traveled around the country and even danced with pop bands full of vigor. He had revived and seemed to do everything right again, showing what a campaign animal he was. His poll rating started rising, and it surged relentlessly, as inflation fell.

In practice, the secret Chubais team took over the Yeltsin campaign from the president's democratically challenged "Party of War." The Chubais campaign was abundantly financed and it ran a modern Western election campaign with all conceivable tricks. The official ceiling for campaign financing was $3 million, but one of the oligarchs told me afterwards that they put up a total of $600 million to finance the elections.[3] This was about as much as the George W. Bush presidential campaign cost in 2004.

The state undoubtedly helped the oligarchs with this funding by allocating cheap treasury bills to them. Gusinsky's NTV stopped criticizing Yeltsin and joined Berezovsky's ORT in providing positive television coverage. Since Gusinsky had the best journalists, his support was most important. An official Yeltsin campaign clip showed a documentary film of how Bolsheviks executed White cadets and burned a church, ending with the words: "Never Again! Vote for Yeltsin!" A campaign poster with Zyuganov's face announced: "This may be your last chance to buy food!" Another poster showed an empty food store in 1991 in black and white, while its other half showed the colorful grocery store with plenty of food (Klebnikov 2000, 234). Russia had not gone through real decommunization, which made raw anticommunist propaganda feel fresh. Yeltsin stood for freedom and modernity.

"If the Yeltsin campaign was hopelessly corrupt, the Communist candidate, Gennady Zyuganov, was hopelessly dull," observed Klebnikov (2000, 224). The communists reinforced their threat. On March 15, 1996, when the election campaign was gaining momentum, they instigated a vote in the Duma overwhelmingly repealing the 1991 agreement on the dissolution of the Soviet Union, substantiating the fears that they wanted revenge (Hoffman 2002, 337). Naturally, they suffered from poor media coverage and limited financial resources, but they could have done so much more with half a million active members.

The campaign was full of drama, but the battle between Yeltsin's two campaign teams was as prominent as their struggle with Zyuganov. In mid-March, the Soskovets-Korzhakov-Barsukov team had drawn their logical conclusion: Yeltsin could not win a democratic election. They almost convinced Yeltsin to undemocratically postpone the elections for two years, but during two dramatic days Chubais, Chernomyrdin, and Minister of Interior Anatoly Kulikov persuaded Yeltsin not to do so (Hoffman 2002, 337–40). And Yeltsin continued to advance in the polls, overtaking Zyuganov.

The first round of the presidential elections took place on June 16, 1996. The excitement was unbearable. Yeltsin won 35.8 percent of the votes cast against 32.5 percent for Zyuganov. In third place came General Aleksandr Lebed with 14.7 percent. He had made a stellar military career, having been a paratroop commander in Afghanistan, the commander of the fourteenth army in Transnistria in Moldova, and one of the rebels swinging behind Yeltsin during the August 1991 coup. Lebed had a strong popular appeal with his deep authoritative voice and habit of speaking in proverbs.

3. Klebnikov (2000, 220) cited "easily over $1 billion," which I think was an exaggeration.

Table 5.2 Results of presidential election, 1996 (percent of votes)

Candidate	First round, June 16, 1996	Second round, July 3, 1996
Boris Yeltsin	35.8	54.4
Gennady Zyuganov	32.5	40.7
Aleksandr Lebed	14.7	–
Grigory Yavlinsky	7.5	–
Vladimir Zhirinovsky	5.8	–
Others or against all	3.8	4.9
Voter turnout	69.8	68.9

Sources: Colton (2000, 234–35); McFaul (1997, 59).

Yavlinsky came fourth with 7.5 percent. Gorbachev decided to stand again, but he received a pitiful 0.5 percent of the votes cast (table 5.2; Colton 2000, 234–35).

The internal drama in the Yeltsin camp was even greater between the two rounds. Lebed was won over to Yeltsin's side, and on June 18, he was appointed secretary of the Security Council, whereas Yavlinsky refused to endorse either candidate. On that day, Korzhakov arrested two of Chubais' collaborators carrying a box with half a million dollars in cash out from the government headquarters. The chips were down. Through his action, Korzhakov forced Yeltsin to choose which team to oust. With their new ally Lebed, Chubais and the oligarchs won and Yeltsin sacked his closest collaborators and friends, First Deputy Prime Minister Soskovets, Head of the Presidential Security Service Korzhakov, Chairman of the FSB Barsukov, and Minister of Defense Grachev, turning an important political page. At the same time, Yeltsin abolished Korzhakov's Praetorian Guard, the Presidential Security Service.[4] However, for Yeltsin it was a serious personal setback to sack his closest drinking buddies. Soon afterward he suffered a severe heart attack that was not publicly acknowledged until after the elections. In the second round on July 3, Yeltsin won convincingly with 54.4 percent against Zyuganov's 40.7 percent (table 5.2).

The threat of a communist revanche was averted by largely democratic means. The voting results concurred with underlying popular opinions (McFaul 1997, Colton 2000). After the elections, however, little happened, because in the fall of 1996 Yeltsin was out of action for several months be-

4. In the fall of 1996, Korzhakov held a press conference to accuse Berezovsky of having repeatedly asked him to assassinate Gusinsky, but Korzhakov said that he thought Gusinsky was a nice man, so he saw no reason to murder him. Seemingly, Korzhakov did not realize that by making this accusation he presented himself as in the business of contract murders, as was widely rumored at the time (Klebnikov 2000, 256). In his scandal-mongering memoirs, Korzhakov (1997) published extensive records from his eavesdropping, as if that was normal.

cause of illness and heart surgery. Chubais became his chief of staff, but in Yeltsin's absence Chernomyrdin became more powerful than ever. The government changed little, but it bore Chernomyrdin's imprint, being dominated by his gray men of upper middle age. An exception was one oligarch, Potanin, who became first deputy prime minister for economic affairs, but he accomplished little apart from restructuring more than $1 billion of tax debts to the benefit of his Norilsk Nickel (Klebnikov 2000, 253). The hope of further economic reforms was elusive.

Lebed, however, acted fast. He used his status as a military hero to conclude a cease-fire in Chechnya with new Chechen President Aslan Maskhadov in August. In effect, Chechnya became independent in all but name. Russia withdrew its troops from Chechnya and let the Chechens manage themselves. To the Russian public, this was a great relief. Lebed behaved as the new heir apparent, being outspoken and even insulting to Yeltsin, who predictably sacked Lebed for insubordination on October 17. Two weeks later, Berezovsky was appointed deputy secretary of the Security Council with special responsibility for Chechnya (Hoffman 2002, 363; Klebnikov 2000, 236, 256). After Lebed had brokered the armistice in Chechnya, he alleged that Berezovsky told him: "What a business you have ruined. Everything was going so well. So, they were killing each other, but they've always been killing each other and always will be" (quoted in Klebnikov 2000, 258).

False Dawn of Reform: The Bankers' War, 1997

The year 1996 had been devoted to defeating the communist threat, and no reforms were undertaken. During his election campaign, Yeltsin promised every conceivable group some benefits, which undermined the budget, although the most excessive promises were reversed after the elections. Suddenly, Moscow realized that apart from privatization minimal reforms had been undertaken since 1993. Once again, the mood was: "We can no longer live like this!"

By early 1997, Yeltsin was back in good health, drinking less after his heart surgery and the departure of his drinking buddies. Full of energy and confidence, he wanted to complete his economic reforms, in which he had not been so interested since the fall of 1991. The election campaign had brought the reformers closer to Yeltsin, and his daughter Tatyana provided them with a strong personal link to the president.

In early 1997, Yeltsin replaced the ineffective Potanin with Chubais as first deputy prime minister for the economy. In addition, one of Yeltsin's favorites, Boris Nemtsov, the young and charming governor of Nizhny Novgorod, was lured to become another first deputy prime minister. At the time, Nemtsov was Russia's most popular politician. Once again Yeltsin revitalized the government with young reformers in their 30s, but

Chernomyrdin was left as prime minister. US Deputy Secretary of Treasury Lawrence Summers, who followed the Russian reforms closely, exclaimed that this was a "dream team."

The government's idea was that big complicated reforms that could not be undertaken in 1991–93 should be carried out. Nemtsov and Chubais declared that the period of "bandit capitalism" was over and that the time had arrived for a normal, honest market economy or "people's capitalism." Yeltsin promised them full support. They put the emphasis on structural reforms (Hoffman 2002, 366; Klebnikov 2000, 269–70).

Because of Yeltsin's support and Nemtsov's popularity, the reformers thought that they could overrule the oligarchs. They also reckoned that the oligarchs understood that the rules of the game had to be normalized. As in 1991, the reformers talked about themselves as a kamikaze government, which could do nothing but undermine their credibility.

Fearless, Nemtsov attacked Gazprom, Russia's wealthiest company, which was finally registered as a monopoly, and the reformers tried to tax it normally. They also questioned the management's right to vote for the government's shares (Slay and Capelik 1997). An equally unpopular idea was to force the oligarchs to pay taxes. Some of them were already paying millions of dollars in personal income taxes, but most did not (Fedorov 1999a, 199–200). The reformers insisted that Russia would hold open privatization auctions for the remaining big state companies. Nemtsov also wanted to deprive the oligarchic bankers of their privileges as authorized banks to hold state funds for minimal interest payment.

The oligarchs, however, knew they had helped Yeltsin to win the presidential elections. Now it was payback time. The tension between the reformers and oligarchs came to a crunch in July 1997. The government had decided to privatize one quarter of Svyazinvest, a state holding company that held controlling stakes in all Russia's regional wireline companies. Gusinsky, who had been left out of the loans-for-shares deals, had long eyed Svyazinvest and considered it promised to him. He formed a consortium with Fridman from Alfa Bank, who had also been excluded from loans-for-shares. Fridman asked: "Why did [privatizations] have to become fair at this particular moment?" (quoted in Freeland 2000, 280). Their consortium was supported by Berezovsky, although he had no direct commercial interest. He opposed the reformers because Nemtsov had blocked him from becoming chairman of Gazprom, and he favored corruption. In addition, he wanted to be the senior oligarch.[5]

However, Potanin decided to compete in the Svyazinvest auction, and he was not deterred by all the other major oligarchs ganging up against him. The auction took place in Moscow on July 25, 1997, and Oneximbank with partners won with a bid of nearly $1.9 billion. This was several times

5. Interview with Nemtsov, June 30, 2007.

more money than the government had received for any prior privatization, and it was the most transparent and honest large privatization auction Russia ever held. One of Potanin's partners, George Soros, later exclaimed: "It was the worst investment of my professional career" (quoted in Klebnikov 2000, 282), clarifying that the price was too high.

The other major oligarchs, however, were teeming with fury, ganging up behind Gusinsky and Fridman and launching "the bankers' war." Gusinsky and Berezovsky's media empires alleged that this most honest privatization auction had been one of the most shady, and the Russian public needed little convincing that a privatization had been corrupt. Gusinsky's muckrakers dug and in August they found that Chubais' protégé, Minister of Privatization Alfred Kokh, had received a hefty advance of $100,000 for a book about Russia's privatization from a company related to Oneximbank.[6] In addition, he was personally entertained by Potanin. Yeltsin sacked Kokh in short order.

On August 18, Chubais' chief ally in his native St. Petersburg, Deputy Mayor for Privatization Mikhail Manevich, was shot dead by a sniper in his car on Nevsky Prospekt, the city's main street. The murder shocked Chubais, who saw it as a warning to himself. As usual, the murder was never solved, so its meaning remains uncertain. The reformers took their revenge and had Berezovsky sacked from the Security Council on November 5 (Freeland 2000, 288–90; Klebnikov 2000, 273–74).

It was going to get even juicier. Yeltsin called six leading bankers to the Kremlin for a meeting in September 1997, telling them to make peace (Hoffman 2002).[7] The oligarchs just laughed it off. On November 12, Gusinsky's able muckrakers revealed another book contract. Five of the young reformers, including Chubais himself, had received advances of $90,000 each for a book on Russian privatization.[8] The generous publisher was controlled by Oneximbank.

These book contracts were undoubtedly legal, but of course ethically dubious.[9] Yeltsin himself had established this standard. The budding authors knew of Yeltsin's book contract with Berezovsky, but the public did not. By contemporary Russian norms, few violations or payments to officials were as small as these, but they were evident and concrete. For ordinary Russians, the sums were not small, and NTV and ORT hammered the young reformers. Kokh's successor as minister of privatization, Maxim Boycko, was forced to resign after only three months in office, as were two other senior Chubais allies (Freeland 2000, 291–92). For Chubais, who had

6. This substantial book was published one year later, Kokh (1998).

7. The bankers were Khodorkovsky, Gusinsky, Smolensky, Potanin, Vinogradov, and Fridman.

8. Also this excellent book was published in due order, Chubais (1999).

9. They would have been legal also in the United States.

the reputation of being as severe—but personally clean—as a Jesuit, this affair was highly damaging. Gusinsky and Berezovsky had successfully brought the reform offensive to a screeching halt.

The reform government had been devastated, before it managed to get anything done. The reform attempts of 1997 turned out to be a false start, although a substantial reform agenda had been set. All the big economic and social issues had been analyzed and plenty of sound policy advice had been elaborated upon. The professional reform debate of 1997 set the stage for Russia's economic revival, but it had to wait for a few years. It laid the intellectual foundation for the reforms of 2000–2003 (chapter 6).

The media oligarchs defeated the young reformers in the fall of 1997, but they were not alone. Prime Minister Chernomyrdin was not part of this reform offensive, and his beloved Gazprom was not weakened. A coalition of communists and nationalists held a majority in the State Duma, and they did not accept any reform legislation. The regional governors, who were powerful and deeply entrenched in corruption, could also block any reform legislation.

It is curious that the reformers thought anything could be done in 1997. Once again, they overestimated Yeltsin's strength and his support for market reform. But they felt that the time had matured. The state was growing stronger and making its comeback. After years of talk about the state having been privatized, the state was becoming nationalized. The reformers realized that the oligarchs could not survive if they did not adapt to a normal market economy, but most of the oligarchs, notably Berezovsky and Gusinsky, did not. Their opposition would cost them dearly. The reformers had expected some resistance from the oligarchs, but not that they would approach self-destruction. Gaidar passed the judgment: "We did not foresee how short-sighted the strategy of the so-called oligarchs would be, to what degree they would prove unable to understand their own self-interest" (quoted in Freeland 2000, 274).

The strife raged also among the oligarchs. The oligarchy was over after the presidential elections, and the usual ruthless competition had returned, even though murder was no longer perceived as a permissible means in Russian big business after 1994. The oligarchs were important, but the role of oligarchy was much exaggerated. The Russian chronicler of the oligarchy Yakov Pappe (2000, 22) assessed Russia's "oligarchy":

> Russia has had no economic oligarchy . . . coalitions of big Russian companies or individual businessmen were local, opportunistic, and short-term. They cooperated for one political or economic purpose and simultaneously they fought one another over other issues. The only broad coalition of big business emerged for the presidential election in 1996 . . . [but] it existed for only half a year before the elections and three-four months afterwards.

The unintended consequence of the bankers' war was that Yeltsin's second term was effectively over. Only a year into his second five-year term in office, he was a complete lame duck. The two groups of protagonists that had fought for him in the elections—the reformers and the oligarchs—had self-destructed through internecine struggle. The red-brown majority in the parliament wanted nothing but to impeach him, an issue that popped up from time to time. Yeltsin was left alone with limited abilities to act in spite of his purported superpresidential constitution. Russia was rudderless.

The Financial Crash of August 1998

The late Rudiger Dornbusch used to say that a financial crisis usually starts later than anybody could imagine, but when it starts, it goes faster than anybody had imagined.[10] That was true of Russia's financial crash in 1998. The country had violated so many rules of macroeconomic policy for so long that the culprits who had benefited from the loose fiscal policy felt nothing but secure.

Russia's standby agreement with the International Monetary Fund (IMF) in the spring of 1995 brought down inflation, but fiscal policy remained too loose, whereas monetary policy was very strict. This unfortunate combination forced the government to borrow extensively to finance its large budget deficit, primarily through domestic treasury bills at outrageous real interest rates lingering around 100 percent per annum. Access to the treasury bill market was limited to privileged Russian banks, excluding both foreigners and households, making it a bonanza of rent seeking. The IMF insisted on opening this market to foreign investors, which lowered treasury bill yields, but it also exposed Russia to a dangerous dependence on short-term foreign capital, attracted by the abnormally high yields.

Despite the large budget deficit and continued output decline, Russia's economy looked too inviting. The freely floating exchange rate showed a tendency to rise, so in the summer of 1995 the authorities introduced a currency band for the ruble exchange rate to impede its rise, prescribing a moderate devaluation instead. This band inspired a false sense of security.

As Russia entered 1996, the communist victory in the parliamentary elections in December 1995 cast a dark shadow. With the presidential elections in June 1996 approaching, the fear of communist revenge dominated Russian politics. Nobody paid much attention to economic policy. The West was enamored with desire to do whatever it could to keep Yeltsin in power (Talbott 2002). Distributing preelection gifts, the government let the budget deficit rise from 6.6 percent of GDP in 1995 to 9.4 percent of GDP in 1996 (figure 4.2). The real yields of the treasury bills peaked at 150 percent a year before the presidential elections, as the government tried to sell more bills than the market was prepared to buy given the political

10. This section draws on Åslund (1998, 1999, 2000).

risks. Almost 4 percent of GDP went to the payment of yields on treasury bills (Illarionov 1998b).

Although nobody in the government was concerned about reform, in the spring of 1996 the IMF concluded a three-year loan program with Russia, an Extended Fund Facility with $10.2 billion in financing. This program lacked all credibility, because it demanded that the budget deficit be slashed to 4 percent of GDP, which was never a serious proposition. This was all too obviously a G-7 political decision to secure President Yeltsin's reelection. Germany and France gave Russia substantial additional credits, allowing the Russian government to increase the budget deficit further.

Yeltsin survived, but these unconditional credits harmed Russia's economic policy. The soft IMF agreement convinced foreigners and Russians alike that Russia was too big and too nuclear to fail. In September 1996, the IMF delayed one credit tranche, but from that time and throughout 1997 the IMF had little leverage, because the election results and the IMF agreement had unleashed an extraordinary inflow of private foreign portfolio investment (Odling-Smee 2004, 25). Russia was set for a stock market boom that could only lead to a bust.

Foreign portfolio investment skyrocketed from a respectable $8.9 billion in 1996 to an incredible $45.6 billion in 1997, or 10 percent of GDP (RECEP 1999). Roughly half of the foreign portfolio investments went into federal government bonds and the other half into other bonds and stocks. At the peak of the stock market in 1997, foreigners might have owned as much as 30 percent of the market capitalization of some $100 billion. The stock of treasury bills in the summer of 1998 amounted to some $70 billion, of which foreigners held some $30 billion. In addition, substantial amounts of corporate, regional, and municipal bonds had been issued. In July 1998, the accumulated foreign portfolio holdings were at least $65 billion or nearly 15 percent of GDP. In addition, international financial institutions had provided the Russian government with more than $20 billion, or 4.5 percent of GDP, in loans. Ironically, Russia was flooded with foreign financing mainly private but also intergovernmental—after serious attempts at economic reform had faded.

Until October 1997, foreign investors had no reason to complain. Russia was the best performing stock market in the world in both 1996 and 1997 with the stock indexes increasing more than six times from January 1996 to October 1997 (figure 5.1). For foreign investors, Russia had become a magic money-making machine.

Russian capital, however, flew in the opposite direction. After having shrunk in 1994 and 1995, net capital outflows amounted to about $20 billion annually in 1996, 1997, and 1998. Russian businessmen wanted to escape the arbitrary Russian taxation, and they trusted their country's economic policy less than foreign investors did.

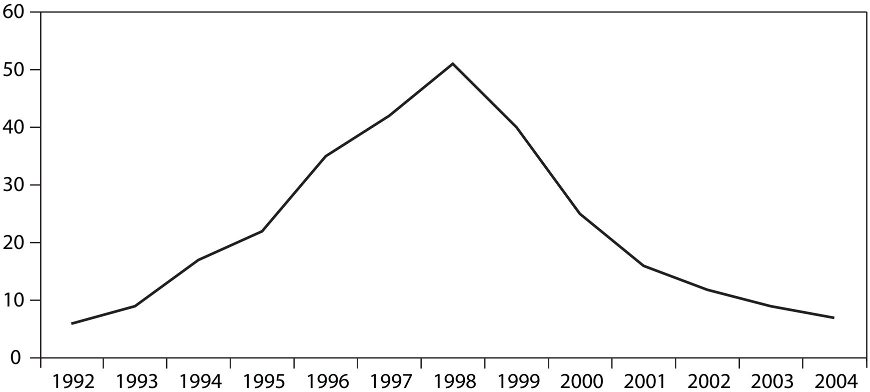
The foreign portfolio investments contributed to the magnitude of the Russian financial crash, and these loans to the Russian government di-

Figure 5.1 Russian stock market index (RTS), 1996–98

Source: Russian stock market website, www.rts.ru (accessed on June 15, 2007).

Figure 5.2 Barter payments in sales of industrial enterprises, 1992–2004

share of barter in total sales, percent



Source: IMEMO (2004).

minished the need for the state to collect taxes or cut subsidies. The conditionality of the IMF loans was ineffective in the presence of such large, unconditional private portfolio investments. The Russian bankers focused on the domestic treasury bill market, and encouraged by the World Bank and the European Bank for Reconstruction and Development (EBRD) they borrowed heavily in foreign currencies, exposing themselves to serious currency imbalances. This was a fools' paradise, and only fools did not buy treasury bills and Russian stocks.

Strangely, barter and nonpayments did not go away in this surplus of money but proliferated. By 1998, about half of all interenterprise payments were made in barter, about one quarter in money surrogates, and only one-quarter in money (figure 5.2). This was not the desired monetization of the Russian economy. The proliferation of barter was confusing and challenging, and many alternative explanations were presented. Communists complained about a shortage of money, requiring additional emissions, but the issue was not scarce supply of money but a lack of demand. Clifford Gaddy and Barry Ickes (1998, 2002) provided the most convincing explanation. They showed that a well-entrenched system offered many actors strong incentives to use barter, because barter and other noncash payments facilitated tax avoidance and evasion.

Barter and offset prices were about twice as high as prices in cash, and businessmen could extract tax discounts by paying with offsets (Commander and Mumssen 1998). If a construction company had not paid its taxes, it offered to build something for the regional government, thus winning an often unplanned public investment project. Offsets were by their nature discretionary negotiations between big businessmen and government officials about large amounts of money, imbued with corruption.

The masters of the barter economy were the big state monopolies, Gazprom and Unified Energy Systems, the state-owned holding company for regional public utilities. In 1996–97, only 7 percent of retail gas purchases were paid in cash, and arrears abounded (Slay and Capelik 1997). Big industrial enterprises used barter to subdue small enterprises. Forty percent of the barter trade was perceived as involuntary, meaning that an enterprise was compelled to accept a payment in products it did not want (Aukutsionek 1998). A second group of beneficiaries were regional governments, which used offsets to divert tax revenues from the federal government to themselves, receiving 60 percent of taxes in money surrogates, compared with 25 percent for the federal government (OECD 1997, Illarionov 1998a). Third, old loss-making, Soviet enterprises that were reluctant to adjust to market conditions were kept alive by subsidies extracted through barter.

The post-Soviet nonmonetary economy was a complex relations economy, benefiting big enterprises, old Soviet enterprises, and regional officials. The losers were the national economy, the consumers, small and medium-sized enterprises (which lived in the overtaxed cash economy), and the federal government (which was starved of revenues). A monetized economy is transparent and competitive, offering fewer advantages to large and old enterprises. Barter was an important structural cause of the financial crash of 1998.

The Asian financial crisis erupted in the summer of 1997, and in late October it hit Russia. On October 28, the Russian stock market suddenly fell from its near peak by 19 percent, and the international credit market tightened. The government was completely unprepared. During that month, Berezovsky worked with the communists in the State Duma and with Prime Minister Chernomyrdin to *increase* the budget deficit to over 8 percent of GDP in 1997 (figure 4.2), not least to undermine the reformers in government. Given that the government had just expanded the deficit, it failed to tighten its fiscal policy until February, and real interest rates shot up to over 100 percent a year again.

On March 23, 1998, President Yeltsin sacked his loyal but passive Prime Minister Chernomyrdin. At the same time, Yeltsin dismissed Chubais and his rival Anatoly Kulikov as deputy prime ministers. Chubais was soon appointed CEO of Unified Energy Systems and started a major reform of Russia's public utilities. Once again, Yeltsin rejuvenated the government. He appointed a 35-year-old bright reformer, Sergei Kirienko, who was seen as a Nemtsov protégé and had been minister of energy. The State Duma was not amused and it approved of Kirienko only one month later on Yeltsin's third attempt, facing the threat of dissolution. It took Kirienko another month to form a government. Mikhail Zadornov, the young

Yabloko deputy and initiator of the 500-day program, had become minister of finance in November 1997, and he was to stay on his post for the next two stormy years as one of the few pairs of steady hands.

The only mystery about Russia's financial predicament was that it had not resulted in a serious crash earlier. For years, the country had maintained a budget deficit of 8–9 percent of GDP. Even in 1998, it was 8.2 percent of GDP (figure 4.2), because the government had refrained from cutting enterprise subsidies. A study by Pinto, Drebentsov, and Morozov (1999) estimated that total Russian budget subsidies amounted to a staggering 16.3 percent of GDP in 1998, of which 10.4 percent of GDP was extracted through barter and nonpayments and 5.9 percent was direct enterprise subsidies. Federal-regional fiscal relations aggravated these problems because most of the revenues stayed with the regional governments that provided the bulk of the enterprises subsidies, whereas the federal treasury was responsible for all debt service on the fast-growing and unsustainable short-term government debt.

By late May 1998, the creditors finally got scared and withdrew on a large scale, and the dollar-pegged exchange rate came under severe pressure. Russian bankers started withdrawing their funds from the country, while foreigners were still attracted by the extraordinary bond yields. Even so, the central bank was swiftly losing its limited currency reserves defending the exchange rate. At this stage, a devaluation would have bankrupted half the banks because of their adverse currency balances.

The Kirienko government was neither fast nor resolute in handling the financial crisis, and it did not possess the necessary political clout to undertake the necessary fiscal adjustment. Politically, it was as isolated as Gaidar's government had been in the spring of 1992. Acknowledging his lack of experience, Kirienko called in Chubais as a special envoy to negotiate with the international financial institutions. The IMF pressured the Russian government to cut the budget deficit, and by July 1998 the government agreed to substantial expenditure cuts and new tax laws to raise federal revenues, not least by transferring taxes from the regions to the federal government. The IMF, the World Bank, and Japan granted Russia a uniquely large additional credit package of $23 billion on July 13. However, the State Duma refused to adopt most of the federal revenue measures proposed by the Russian government and the IMF in the next few days. As a consequence, the IMF issued only a first tranche of $4.8 billion on July 20. The US government passed the judgment that no salvation was possible and did not propose any new measures. Arguably, no amount of credit could have saved the Russian finances at this stage, only substantial and instant budget cuts, and they were not politically feasible (Kharas, Pinto, and Ulatov 2001).

The Russian government was by no means passive, and some of its acts were quite heroic. As the head of the State Tax Service in 1998, Boris Fedorov, the former minister of finance, tried to force Gazprom to pay taxes. He reckoned it necessary to beat the biggest company to convince other big corporations to do so. He found out that Gazprom had made a formal agreement with his predecessor at the tax service that illegally relieved Gazprom from half of its tax liability. When Fedorov went after Gazprom, its management reduced its tax payments, claiming that the federal budget owed it more money than it was supposed to pay in taxes. The government responded by threatening a change of management of Gazprom, and it let the police raid Gazprom's headquarters and its holiday homes. Gazprom CEO Rem Vyakhirev responded by going to Yeltsin and Kirienko. Gazprom's many supporters in the Duma protested against the government's supposedly malign actions. These attempts laid the ground for breaking the power of the big companies and for their effective taxation (Fedorov 1999a, 204–08).

The Russian finances could no longer be saved without devaluation or a default. On August 17, 1998, the government did both. It defaulted on its domestic debt of some $70 billion, and the value of the ruble soon fell by three-quarters. In addition, the government declared a moratorium on Russian banks' foreign payments, which in effect became a general freeze of bank accounts. Once again, ordinary Russian bank savers lost their money, usually about two-thirds of their deposits, and they had to wait in humiliating lines outside the banks for days hoping to rescue some of their savings. Inflation that had fallen to the single digits surged to 85 percent for 1998 as a whole. The Russian stock market hit bottom with a staggering fall of 93 percent from its peak in October 1997 until early October 1998 (figure 5.1). One Western investment banker said that he would rather eat nuclear waste than invest in Russia again (Freeland 2000), but this was of course the ideal time to invest.

About half of Russia's commercial banks went bankrupt, including all the big oligarchic banks save Alfa Bank.[11] The oligarchs' spell as bankers was over and their very survival was under a cloud. The big questions for the country were whether the market economy was over, whether the communists would come back, and whether hyperinflation would erupt. The shock was enormous and so was the sense of national failure. In Moscow, somebody put up unsigned posters with the words: "Nobody will save Russia apart from ourselves." In jest, one of the posters had been signed, "Michel Camdessus," the managing director of the IMF. Russia's self-confidence had hit a new low, but Russians realized they had to take their responsibility.

11. Menatep, Oneximbank, SBS-Agro, Inkombank, Rossiisky Kredit, and Most Bank went bankrupt. The owners of SBS-Agro, Inkombank, and Rossiisky Kredit disappeared from the big business scene.

Three major interest groups pushed their country into this abyss. The main culprits were the oligarchs. The bankers had encouraged the large budget deficit and thrived on the treasury bills, although many of them now suffered badly themselves. Berezovsky had even been talking down the Russian market (Klebnikov 2000, 281). Some oil barons, including Berezovsky, had campaigned for devaluation, although they knew that this would lead to the bankruptcy of most banks. The oil producers wanted lower production costs in rubles and thought little about other consequences (Alekperov 1998).

Second, the Russian State Duma, which was dominated by the communists, refused to accept a government proposal to move from a value-added tax based on payments to accrual basis in July 1998, which would have taxed barter. Nor did the Duma agree to transfer any regional revenues to the federal treasury. These two votes by the Duma triggered the financial collapse.

Third, behind these decisions by the Duma stood the regional governors, who resisted any transfer of their funding to the federal government, although regional revenue was almost one and a half times as large as the federal revenues, and much of it was spent on discretionary enterprise subsidies.

The behavior of all these three groups was socially irresponsible, but based on their own recent experiences, their actions appeared rational. They had learned that the most reckless rent seekers were the most successful. They seized any possibility instantly, considering it better to be seen as cunning and dangerous than honest.

An additional nuisance was that Siberian coal miners had gone on strike in May because they had not been paid their wages. Although the federal government was not responsible, the miners organized protest actions, from blocking railroads to camping outside the White House and beating on their helmets. ORT and NTV covered them so intensely that the suspicion arose that the protesting miners were paid by Berezovsky and Gusinsky.

In his Annual Address to the Federal Assembly on March 30, 1999, President Yeltsin (1999a) sadly summed up the situation: "We have got stuck half-way in our transition from the planned and command economy to a normal market economy. We have created . . . a hybrid of the two systems." It was evident that Russia had to change profoundly, but it was unclear how.

NATO and G-7 Enlargement

Despite Russia's weakness and friendliness, in 1997 the North Atlantic Treaty Organization (NATO) was enlarged to include Poland, the Czech Republic, and Hungary. In order to make sure that Yeltsin was not hurt, the West made Russia a full member of the G-7 at the same time (Talbott 2002). Yeltsin (2000, 131) reported in his memoirs:

> Russia was finally granted full-fledged status [as a member of G-8] in June 1997, at a summit in Denver, Colorado. . . . Paradoxically, I think our tough stance on the eastern expansion of NATO . . . played a role in gaining us this new status.

However, Russia's membership in the G-8 was not all that important. The exclusion from NATO, by contrast, meant that Russia was not included in the Western world, to which it had arguably belonged for two centuries from Peter the Great to 1917 (Malia 1999). Russian liberals felt wounded. Their dream of becoming a part of the West had been pushed aside for the foreseeable future.

Russia's policy toward the members of the CIS did not really evolve. It was characterized by bluster and a lack of realism. Russia came up with one harebrained scheme after the other. The CIS countries closest to Russia obliged by signing, whereas the other half did not. Hardly any country ratified any agreement, and even if they ratified they did not implement them. All these meetings and agreements cost time and effort, and they were utterly unproductive.

Major initiatives were a Russian-Belarusian Union broached in early 1994, a common free trade area for all CIS countries in 1994, and a Customs Union for, first, Russia, Belarus, and Kazakhstan in 1995, and later for Kyrgyzstan and Tajikistan. When the Customs Union did not work, it was renamed the Eurasian Economic Community in 2000 (Olcott, Åslund, and Garnett 1999). In April 1999, Berezovsky was appointed executive secretary of the CIS, and for a year he flew around trying to make sense of the organization until he failed. The CIS was a waste of time, diverting the CIS leaders from more serious international engagements such as their accession to the WTO.

Assessing the Oligarchs

To understand the implications of the Russian oligarchs, a comparative historical perspective is useful. The oligarchs, or Russia's "big business" or "big capital," as they preferred to call themselves, were not real oligarchs in the sense that they ruled Russia. The "rule of the seven bankers" or *semibankirshchina* of 1996 was brief and not characteristic of big business in Russia. Only for nine months in 1996 did the top bankers meet regularly with Russia's top politicians. The bankers played this prominent role and stayed united only because of the virulent communist threat.

The Russian oligarchs changed both their actual persona and their behavior rapidly. They took over from both the state enterprise managers and organized crime. They were more skillful than the old managers, especially in the financial and international sphere, and they proved generally more flexible and entrepreneurial. Tired of paying off racketeers, they set up their own security forces and cleansed their enterprises of organized crime, which old managers usually failed to do.

The oligarchs had enriched themselves as traders, primarily trading oil and metals. At the end of communism, they were all bankers and benefited from inflationary profits. In 1993–94, they thrived on the voucher auctions, opportunistically accumulating stocks in a large number of enterprises. From 1995 until June 1998, they made huge fortunes on domestic treasury bills with high yields. A breakthrough for the oligarchs was the loans-for-shares privatizations, even if only three significant companies—Yukos, Norilsk Nickel, and Sibneft—changed controlling owners. The newly rich entrepreneurs showed that they could beat the most powerful old state enterprise managers. The rise of the oligarchs marked the ascendance of ownership over the management of assets, which profoundly changed the nature of the Russian economy.

Two men stood out, Boris Berezovsky and Vladimir Gusinsky, because they were showmen and each possessed a media empire. As a businessman, Berezovsky belonged to the early stage of rent seekers, when state enterprises were tapped on funds and money was extracted through political contacts. An article in the business newspaper *Kommersant Daily* offered an accurate assessment of Berezovsky's business:

> To destroy Boris Berezovsky's "empire" is easy, primarily because it is based on the fallacious principle "not to own but manage." Berezovsky did not buy control packages of stocks. . . . With support of the Kremlin, he simply put his people on key posts in a company, and they helped him to manage the firm as was necessary for Berezovsky. (Zavarsky 1999)

In a conversation with the late Paul Klebnikov (2000, 170), Berezovsky himself put it similarly: "Privatization in Russia goes through three stages. The first stage is the privatization of profits. The second is the privatization of property. The third is the privatization of debts." Like the state enterprise managers, Berezovsky was best at the first type of privatization, which he exercised at state-dominated Avtovaz, Aeroflot, and ORT. The other oligarchs focused on real privatization of property. Corporate raiders purchased debts of companies to put them into bankruptcy and buy them cheaply.

Vladimir Gusinsky was a very different creature. Although he probably made most of his money on banking and real estate, he was an outstanding media entrepreneur, creating Russia's most interesting television channel, radio channel, and print media. Even if he sometimes used his media for political purposes, the quality of his journalism was eminent.

The financial crash of August 1998 brought about fundamental changes for the oligarchs. Their banks were most exposed to the financial collapse because they were heavily invested in treasury bills that defaulted and they had taken large foreign loans that they could not pay back after the devaluation. Of the big banks, only Alfa Bank and MDM had sold their treasury bills in time and survived. Another effect was the rise of the commodity producers, that is, oil and metals. Out of 26 Russian billionaires identified by *Forbes* magazine in 2005, 12 had made most of their money on metals, nine on oil, and two on coal (Kroll and Goldman 2005).[12] Another major change was that the oligarchs developed lucid corporate strategies. Their corporations remained conglomerates, but most of them concentrated on approximately three core industries. They sold off accidental assets that they had assembled during the privatization.

The ideal business strategy was to have been a banker thriving on treasury bills until May 1998 and then sell the treasury bills and sit on foreign cash until after the August crash. In the fall of 1998, the trick was to buy commodity-producing companies cheaply on the secondary market. Some rising oligarchs did exactly that, notably the owners of MDM Bank, Andrei Melnichenko and Sergei Popov, who were only in their 20s. In June 1998, they smartly sold all their treasury bills, and after the crash they started buying up privatized coal mines, eventually accumulating one-third of Russia's coal production in their company SUEK. They turned their coal mines around in no time, decriminalizing them, laying off workers, boosting coal output, and thus achieving good profits without state support in an industry that had lived on subsidies.

In late 1999, Oleg Deripaska and Roman Abramovich, both in their early 30s, bought most of Russia's aluminum production from the infamous brothers Mikhail and Lev Chernoi (victors of the bloody aluminum wars), and they formed Rusal. Thus, a new generation of even younger oligarchs emerged who did not suffer from the (unjustified) stigma of the loans-for-shares privatizations. Purchases of already privatized enterprises were politically much more acceptable than purchases directly from the state, which were invariably seen as corrupt.

The development of Khodorkovsky's Menatep group is fairly representative. Initially, it was Bank Menatep. In 1994–95, it became the industrial conglomerate Rosprom with 200 mismanaged enterprises. After the collapse of Bank Menatep in 1998, it became the oil company Yukos, which in 2000 became the best managed Russian oil company together with Sibneft, whereas most of Rosprom was sold off.

Fridman's Alfa Group offered another clear-cut strategy. Uncharacteristically, Alfa Bank remained the heart of this group. Only after the loans-for-shares did Alfa buy an oil company, TNK, which became its main money spinner. Alfa also bought a large part of Vimpelcom, an excellent start-up mobile phone operator. Alfa's purchase boosted Vimpelcom's share price, because Alfa could help this squeaky-clean company to obtain licenses in regions outside Moscow. Alfa's fourth major business line was retail trade.

12. Yukos, Lukoil, Surgut, TNK, and Sibneft in oil; Rusal, SUAL, Norilsk Nickel, Severstal, Evrazholding, NLMK, MMK, Mechel, and UMMK in metals.

Other large business groups looked similar. Usually, they had an oil or metals company as their cash cow. They poured the cash into manufacturing, consumer industry, or retail trade.

Comparing integrated business groups in Russia and the United States, Aleksandr Dynkin and Aleksei Sokolov (2002) found that big American business groups before the US stock market crash of 1929 tended to be as diversified as Russia's groups before its 1998 crash. In a similar fashion, business groups in both countries were streamlined after the respective financial crashes. Randall Morck, Daniel Wolfenzon, and Bernard Yeung (2005, 693) surveyed recent literature on ownership around the world and concluded: "Control pyramids effectively entrust the corporate governance of the greater parts of the corporate sectors of many countries to handfuls of elite, established families, who can quite reasonably be described as *oligarchs*." Rather than considering oligarchs an exception, as most of the Anglo-American literature about Russia does, we must accept them as the international norm. The two exceptions without concentrated enterprise ownership are the United States and the United Kingdom (La Porta, Lopez-de-Silanes, and Shleifer 1999).

Economically, the oligarchs went through a gradual transformation from rent seekers to profit seekers, from parasites tapping the assets of the state to full-fledged owners and investors. As conditions stabilized, their time horizon grew from one day to the long term. Until 1998, many of them could be criticized for asset stripping and the dilution of minority shareholders' ownership, but since 1999 that has hardly been true. The oligarchs have invested heavily; they have displayed large profits; and many of them have paid substantial dividends to minority shareholders. True, they have been more greedy and aggressive than most businessmen, but isn't that what capitalists are supposed to be? Increasingly, the Russian oligarchs have become more like big businessmen in Western countries, only more dynamic, successful, and colorful.

Almost all the oligarchs were not only owners but also managers of their big enterprises.[13] They turned around Russia's old heavy industry, especially the oil and metallurgical industries, using many talents. A first precondition for the successful management of a big Soviet enterprise was good relations with the Kremlin, that is, the federal government, as well as with the regional governor.

Another important skill was to be able to clean out an enterprise of organized crime. The oligarchs sent in their security forces and secured the plants, sacking pervasively criminalized parts of the company such as the transportation department and the construction department, whereas bookkeeping, production, and research were usually decent. The old man-

13. The exceptions were Potanin, whose partner Mikhail Prokhorov was the manager, and Abramovich, who, uncommonly, used hired managers.

agers were contemptuous of financial management and marketing, but the newcomers brought in the big international auditing companies.

Foreign investors are usually afraid of laying off labor, but the revival of a Soviet plant required that the chronic overstaffing was eliminated, and nobody could slim labor forces faster and with less public outcry than Russia's young entrepreneurs. The old Soviet social legislation persisted. Most of it was ignored, but some acts were honored. Russians mastered the real social legislation, which remains an enigma for most foreigners. Similarly, the local authorities posed many demands on major corporations, and able Russian businessmen knew what to do and what to avoid. For instance, when is a charitable donation necessary?

A typical Soviet factory was clogged with superfluous equipment, much of it obsolete, and quite a lot new but never installed. Western investors usually gutted factories, scrapping all the old equipment. Russian engineers, by contrast, knew what made sense in the old machinery and used it, while cleaning out the rest. To them, capital was scarce, making them keen on utilizing the viable physical capital. They often used second-best, but sturdy, Russian equipment, costing a fraction of Western equipment but performing only slightly worse. McKinsey and other Western management consultants were hired to identify bottlenecks, because small investments usually could swiftly raise capacity and quality. Finally, Russian businessmen understood the old management and how to sort it out. Many underwent the best of Western business training at their own expense.

As a consequence of all these peculiarities of big Soviet enterprises, Western business consultants typically advised foreigners to stay away from unrestructured Soviet enterprises with more than 1,500 employees, because they did not know how to manage them. Many big Western investors who did not heed this advice failed miserably. At least at the initial stage of the restructuring of big Soviet plants, Russian oligarchs were far superior to Western businessmen. Fortunately, Russia found ways to transfer large factories to natives who could revive them, in contrast to Central Europe. There, most of the big factories have been closed down because they were either bought by foreigners who failed to manage them, or they were mismanaged by the state for too long and rusted away.

By 2007, the social features of the oligarchs are easy to identify. Most of them are young, just over 40 years of age. They were about to graduate from university when the Soviet Law on Cooperatives was adopted in 1988, which usually formed the legal basis of their first enterprise. Almost all of them are engineers, and several have doctorates in engineering from the best Soviet universities, primarily in Moscow. Their social origins are mostly humble, and many come from the provinces, but the Soviet education system gave them the opportunity thanks to their outstanding mathematical skills. Initially, the dominance of Jews was striking, but ethnically the oligarchs have become more varied. Nearly all the oligarchs manage huge companies. All but one of the current Russian billionaires are men.[14] By all standards, Russia's oligarchs are outstanding self-made entrepreneurs, most of whom made their fortunes on revitalizing existing Soviet mastodons rather than developing new enterprises.

The similarities between the contemporary Russian oligarchs and the American robber barons of the late 19th century are greater than most recognize. Some industries, such as oil and metals, possess great economies of scale, which is a strong reason for concentration of production. The economies of scale are greater in large countries, such as Russia and the United States. Postcommunist Russia was characterized by even more rapid structural change than America during its industrialization and the reconstruction after the Civil War, which promoted the robber barons. In Russia, privatization delivered large assets cheaply to the daring purchasers, and US robber barons benefited from the free distribution of state assets as well, notably land around the railways, and cheap state credits, since multiple early railway investments ended up in bankruptcy because of insufficient state support to reach the desired economies of scale (DeLong 2002).

The US legal system was deplorable in the 19th century (Steele Gordon 2004), and so was the situation in post-Soviet Russia. In the precise meaning of the phrase, post-Soviet Russia was a lawless state. In the early 1990s, Russia lacked most of the necessary laws for a capitalist economy, ranging from property legislation to bankruptcy. To build strong legal institutions takes a long time, and without any forceful legal reformer around, such reforms were always on the backburner.

Poor judicial systems breed poor corporate governance, impeding the evolution of financial markets. Without strong corporate legislation and a potent judicial system, partners find it difficult to agree or resolve conflicts. "When institutions are weak, doing business with strangers is dangerous and unreliable" (Morck, Wolfenzon, and Yeung 2005, 672). Nor can principals (owners) control their agents (executives). But an economy can develop before a strong legal system has evolved. Russia's oligarchs knew how to handle these problems. The concentration of ownership of old Soviet corporations in the hands of a few oligarchs offered great comparative advantages and was often a precondition for the survival of these companies.

An early empirical study of Russian financial-industrial groups in the mid-1990s found that they were already more efficient in their real investment than independent owners (Perotti and Gelfer 2001). Businessmen with concentrated ownership were more successful than those who had to deal with many minority shareholders. Because of difficulties controlling

14. The single woman is Yekaterina Baturina, the wife of Moscow Mayor Yuri Luzhkov; she has proved highly skillful in Moscow real estate.

managers, owners were compelled to manage their companies themselves. Businessmen avoided concluding too many contracts that they could not secure in court by rationally opting for vertical integration; that is, they preferred corporate hierarchies to horizontal markets (Williamson 1975).

The oligarchs arose as an economically and legally rational response to adverse conditions to business. They could influence the conditions and sometimes caused considerable damage. Some leading oligarchs, notably Berezovsky, bore some responsibility for the financial crash of 1998. However, considering how diverse the oligarchs were, how swiftly they altered their behavior, and the extent to which their names changed, they were much more takers from than creators of the business environment. Of the seven dominant oligarchic banks in 1998, only one survived, and only two of the seven leading oligarchs, Fridman and Potanin, are still important in Russian business. The oligarchs' absence of staying power shows how dangerously they lived and consequently how limited their power really was. Yet, they salvaged and transformed the giant Russian factories, and enabled these companies to lead Russia's economic revival.