PUTIN’S FRIENDS AND THE POWER OF OIL

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It used to be said that power comes out of the barrel of a gun. Looking back at global politics over the past few years, it is becoming increasingly clear that real power nowadays comes out of a very different barrel, namely that which contains oil. The implications are considerably more profound than idle speculation about links between the US oil lobby and the decision to go to war against Iraq. What is really at stake is the ongoing reconfiguration of global political and economic power, between the leading producers and consumers of the black gold.

In the US media there has been a long-running debate over an allegedly unhealthy relation between the US and Saudi Arabia. The trauma of 9/11 brought increased intensity to this debate, with pointed allegations of shady dealings to cover tracks leading to prominent members of the House of Saud. The extent of veracity in such allegations is beside the point here. The point of the argument rather concerns the European scene, where the growing might of Russia as a supplier of both oil and – especially – gas is giving rise to a similar debate about unhealthy European relations to the Kremlin.¹

At the core of this debate we may find Germany, which presently gets 35 percent of its oil and 40 percent of its gas from Russia. As plans continue, moreover, for a further winding down of the country’s nuclear industry, those are figures that stand to increase greatly.² It is thus hardly surprising that in Chancellor Gerhard Schroeder the Kremlin would find an understanding friend, to be relied upon in times of bad press or when the EU might try to get tough.

The true nature of this “strategic friendship” has been given ample and at times somewhat unpalatable illustration. In the aftermath of the September 2004 elections in Chechnya, criticized by the EU as being neither free nor fair, Schroeder rallied to his

² Ibid.
friend’s side, calling Putin “a democrat through and through,” and claiming that he “could not detect any sensitive disturbances of the democratic process.”³ A few weeks later, when the world was gearing up to condemn Putin’s involvement in the fraudulent Ukrainian presidential election that provoked the “Orange Revolution,” Schroeder again came to the rescue, calling Putin a “flawless democrat,” and maintaining that “I am thoroughly convinced that the Russian president wants to transform Russia into a democracy and that he is doing so out of deeply held conviction.”⁴

The presumed purpose of this kowtow was to pave the way for reciprocating deals for German industry, an ambition that inevitably would involve close personal involvement with the inner circles of power in the Kremlin.² Symbolically, the crowning edifice of the partnership was timed to take place only ten days before the September 2005 national elections in Germany, where Schroeder’s Social Democrats were trailing badly in the polls.

Announcing that Russia’s Gazprom and Germany’s E.On and BASF had signed a deal to build a gas pipeline from Vyborg to Greifswald,⁶ Putin and Schroeder also de facto announced that they had jointly decided to fundamentally alter Europe’s energy infrastructure. Fears expressed both by Poland and by the Baltic republics, that they were now being bypassed and might in a situation of crisis be simply cut off from Russian gas,

⁴ According to Sergei Kovalyov, Russia’s former human rights commissioner, Germany is quite simply “sacrificing long-held beliefs in human rights and democracy for a powerful friend and a few euros.” This he branded as not just morally wrong, but also dangerous.” (Spiegel Online, December 1, 2004 www.spiegel.de). The televised quip about the “flawless democrat” has attracted particular outrage. The head of a German government-affiliated think-tank, speaking on conditions of anonymity, even went so far as to say that “Given Moscow’s history of strong-arming neighbors, we might want to think whether we really want to be in such a relationship.” (Steltzer, op. cit.)
⁵ As actual developments would show, there are no guarantees involved in such games. A key project that Schroeder had surely hoped to see come through was Siemens’ desire to purchase 71 percent of Silovye Mashiny (“Power Machines”), a Russian heavy machinery maker. The deal was agreed in July 2004, but was subsequently blocked. The reason given was national security considerations, based on the fact that a minor part of the enterprise (Kaluga Turbine Works) is on defense contracts. Once that part had been spun off, Energy Minister Viktor Khristenko suddenly discovered that defense secrets were to be found throughout the company (http://www.kommersant.com/page.asp?id=-4186).
⁶ The pipeline will be placed on the Baltic Sea bed, for a length of 1,200 kilometers. It is intended to have branches running to Sweden, Finland and the Kaliningrad region. (The two leaders’ joint press conference is reported on Johnson’s Russia List, September 8, 2005, item 23.)
were dismissed by Schroeder. Unsurprisingly, Poland subsequently called for the EU to develop a joint energy security policy, akin to the “musketeer” principle of NATO, where all other members will come to the rescue if one should be left without deliveries of gas.

Rounding it all off, and underscoring just how personal relations with the Kremlin may become, only weeks after the election defeat of the German Social Democrats, it was announced that by then former chancellor Schroeder was slated for a plum job at the new pipeline consortium. As the old Russian saying goes, “one hand washes the other.”

The bottom line of the gas deal is that it offers conclusive evidence of just how crucial the Russian energy complex has become. It has supported a tremendous turnaround of the Russian economy, it looms ever larger in Russian foreign policy, and it constitutes the main arena for domestic struggles over the allocation of rights to ground rents. Most importantly, however, it provides the main impetus for an ongoing extreme makeover of Russia’s political landscape, and thus also offers serious implications for the outlook both for further reforms and for relations to the West.

In the following we shall approach these matters in three steps. We shall begin by looking at the overall impact of the Russian oil boom, which sets the stage for the discussion. Focus will then be shifted to the dismal legacy from the Yeltsin era, which provides the challenge to Vladimir Putin, and the remainder of the paper will show how Russia’s political landscape is being reconfigured, to fit once more into the old Muscovite mold.

The Oil Boom

For the Russian Federation, the most visible effect of the protracted boom in hydrocarbon markets has been to drastically alter the image of the country as debt-ridden economic

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7 Several Polish media referred to the deal as a new “Molotov-Ribbentrop Pact.” See further BBC News, September 8, 2005 (http://newsvote.bbc.co.uk), and Deutsche Welle, September 8, 2005 (http://www.dw-world.de).
8 The deal was followed by a barrage of criticism not only from domestic German media and political opponents (Washington Post, December 10, 2005). Even in traditionally neutral and low key Sweden there was outrage, with one of the country’s largest circulation papers editorializing that “Gas Stinks” (Expressen, December 13, 2005). The financial benefit to Schroeder has not been revealed.
basket case. In the final years of the Yeltsin era, few believed that there would be economic recovery of any sort; many even feared that there would be a massive sovereign default, involving some $150 billion in debt. In the spring of 1999, *The Economist* captured the general sentiment on markets that had just been badly stung by the August-98 crash, and could see little hope for the future.

Having long aspired to become a member of the “G7” club of the world’s wealthiest nations, Moscow now faced a risk of being relegated to a “P7” club of financial pariahs, where it would have joined the ranks of countries like Sudan, Liberia, Congo and Somalia, “poor, war-ridden places, some barely existing as states,” which had borrowed money from the IMF and failed to repay their debts. For good measure, the magazine also quoted an American investment banker claiming that he would rather eat nuclear waste than have further dealings with Russian debt.  

Outside the world of finance, other voices found even more alarming grounds for concern. Former CIA analyst Fritz Ermarth pointed at what many feared might be the real implication of the meltdown: “What if the Russians simply cannot make it?” Ermarth worried that it was the very notion of “civilization” that was at stake: “What if the post-communist experience of Russia means that the ‘self-evident’ truths of Jefferson and Lincoln are not for all people but only for some? ... The perils of nuclear and other junk emanating from Russia are frightening enough. But the grim possibility at stake in the Russian experience – that civilized self-government is not for all people – is more frightening still.”

When President Putin had served out his first term, and sailed effortlessly past the mere formality of re-election, all such imagery of doom and gloom had been long forgotten. The economy was growing, trade was booming, and the federal budget was solidly in the black. Above all, debt service was no longer an issue of concern. The massive inflow of petrodollars had caused Central Bank reserves to repeatedly surpass all

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10 Ermarth, Fritz W. (1999), “Seeing Russia Plain: The Russian Crisis and American Intelligence,” *The National Interest*, no. 55, spring, pp. 5-6. As late as May 2001, *The Atlantic Monthly* could still feature an article with the provocative title “Russia is Finished.” It should be noted that this pessimism was not shared by all Russia watchers. Much as there were dissident voices speaking out against the glossy view of the Yeltsin reforms, there were dissidents arguing that post-crash developments might turn out far less dismal (e.g. Hanson, Philip (2003), “The Russian Economic Recovery: Do Four Years of Growth Tell Us That the Fundamentals have Changed?,” *Europe-Asia Studies*, vol. 55, no. 3.)
previously thinkable limits, rising from a measly $12 billion at the outset of 2000, to a staggering $182 billion by the end of 2005. At the latter point, Russia could have easily redeemed all its remaining foreign debt and still have a good-sized pile of cash to spare.

Another important effect of the increased windfall from oil and gas has been to drastically alter the performance of fiscal policy. The revenue side has been boosted not only by increased export duties and by a toughening stance by the tax man against the oil majors. Economic growth and an associated re-monetization of the economy have also provided growing indirect revenues. As the federal government itself began scaling back the previously noxious practice of non-payments, inter-enterprise arrears began falling as well. This not only brought comfort to pensioners and wage earners, who were increasingly paid on time. By deflating the famed “virtual economy,” it also provided increasing bite for the traditional instruments of fiscal and monetary policy, such as tax and interest rates. (If financial markets, for example, do not provide credit for investment in the real economy, the interest rate ceases to be of much interest.)

A particularly important effect of this strengthening of the federal budget has been that of helping boost credibility. Realizing that a sudden drop in the world market price for hydrocarbons might wreak substantial havoc, to the point even of returning the economy to the bad old days of threatening default, it was decided in December 2003 to introduce in the budget for 2004 a special Stabilization Fund. Designed to receive oil revenue over a certain limit (initially $20 per barrel of Urals oil), it was to be used as a cushion to absorb fluctuations in export revenue.

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11 Numbers taken from the Central Bank of Russia web page: www.cbr.ru.
12 Total foreign debt owed by the federal government at the end of 2005 (September) stood at $70.8 billion. Of this, $34.9 billion was debts inherited from the former USSR, and $35.9 billion was “new Russian” debt. Of the former, $22.4 billion was debt to the Paris Club, and of the latter $23.5 billion was Eurobonds, mainly issued as part of a restructuring deal with the London Club of commercial creditors. While it is thus clearly the case that sovereign debt no longer presents a problem, it is worth bearing in mind that there is a parallel expansion of foreign borrowing by banks and “non-financial enterprises.” At the end of 2005, the former owed $43.5 billion, and the latter $103.4 billion. (All numbers taken from www.cbr.ru.)
14 The exact specifications said that the Fund would receive revenue from three different sources, namely a part of export duties on oil and petroleum products, together with part of the tax on ground rents, and a part of the federal budget surplus at the outset of the year. Legislation on the Stabilization Fund was preceded by the maintenance of an informal “strategic reserve” within the budget.
Although the arrangement was subjected to much criticism, the overall outcome must be deemed a success. Those who claimed that the ceiling of 500 billion rubles (at the time $18 billion), under which no payments out of the fund could be made had been set too low were rapidly vindicated. By February 2005, the fund had reached 740 billion rubles ($26.5 billion), and by the end of 2005 it stood at 1.46 trillion ($52 billion).\textsuperscript{15} Despite the fact that extra funds have thus been available, the government has succeeded in resisting demands for the money to be spent on domestic issues, prudently using the extra revenue to pay down foreign debt. Over the past year, the IMF was paid off in full, and the Paris Club received $10 billion in early repayment. More of the latter is to be expected.\textsuperscript{16}

With forecast revenues of $174 billion, the federal budget for 2006 not only provides room for increases in previously grossly neglected social spending. It also complements the Stabilization Fund, by introducing a strategic Investment Fund, to fund special projects on a competitive basis. When the budget was passed, in December 2005, it was expected that by the end of 2006 the Stabilization Fund will hold $77 billion and the Investment Fund and additional $2.4 billion.\textsuperscript{17}

As a crowning achievement, bringing much pleasure to the previously battered stock market, the massive inflow of petrodollars has also had a tremendous impact on the heavily energy-dependent Moscow stock exchange. From a trough of 38.5 in the immediate aftermath of the 1998 crash, the RTS index recovered slowly at first, hovering around 200 for most of 2000. The real climb began in 2001, and over 2005 alone it almost doubled (rising from 607.6 to 1,125.6).\textsuperscript{18} Further impetus for the rally may perhaps be derived from the recent lifting of the “ring fence” around Gazprom, which had precluded foreign investors from buying Gazprom shares directly. Some have speculated that as a result of this move, Gazprom capitalization may increase from $100 billion to $600 billion.\textsuperscript{19}

\textsuperscript{15} \textit{The Russia Journal}, February 23, 2006.
\textsuperscript{16} According to Finance Minister Kudrin, the ambition for 2006 is to repay $11-12 out of a remaining $21 billion (\textit{RIA NOVOSTI}, February 9, 2006). An important reason why the Paris Club has not been paid off at a faster rate lies in the fact that Germany, which holds the bulk of the debt, has issued bonds of its own that are linked to the Russian debt. Moscow was understandably less than amused at this move.
\textsuperscript{17} \textit{Moscow News}, December 7, 2005.
\textsuperscript{18} Numbers from \textit{www.rts.ru}.
\textsuperscript{19} \textit{Moscow News}, December 9, 2005.
Beyond all this good news, there are, however, numerous sinister implications also to be taken into account. Markets are haunted both by the specter of inflation and by the danger of “Dutch disease” that follows from the steady revaluation of the ruble.\textsuperscript{20} Much needed economic reforms are dead in the water, and analysts have begun taking a second look at what is really hiding behind the glossy image of solid and broad-based growth that is projected by official statistics.

According to Goskomstat, for example, energy accounts for less than nine percent of Russian GDP, with a presumably vibrant service sector contributing 60 percent (49 percent being market services, and only 11 percent originating in the public sector). The image that is conveyed by such numbers, and that is reinforced by Kremlin spin doctors, is that of a diversified economy and a growing middle class that will form a much-needed basis for evolving such norms and values that are associated with democracy and a rules-based economy. Reality, unfortunately, has a very different story to tell.

In its \textit{Russian Economic Report} from February 2004 the World Bank expressed great surprise that energy could be said to account for such a small fraction of GDP, while the same official numbers claim that oil and gas exports account for no less than 20 percent of GDP.\textsuperscript{21} The simple answer was that for reasons of tax avoidance/evasion, Russian oil companies were using elaborate transfer pricing schemes to shift revenues out of their core businesses and into trading companies that in some instances were quite nebulous. While this made life harder for the tax man, it also gravely distorted the image of where Russian GDP is being produced.

Setting out to correct for such distortion, the analysts began by noting that while trade and transport margins for oil and gas in the Netherlands and the UK are zero, in Russia the former stands at 35 percent and the latter at 63 percent. With these bogus margins reassigned to their proper source of origin, it at once transpired that energy

\textsuperscript{20} It is important here to differ between changes in the nominal rate of exchange, which is recorded on the market, and the real rather of exchange, which is adjusted for differences in the rate of inflation between countries compared. It also should be noted that are several different ways of defining the real effective exchange rate, all depending on what weights different currencies are given. The simplest is to measure only against the dollar or the euro. According to the measure that is used by the IMF, the ruble appreciated by 18.7 percent in 2001, by 3.3 and 3.5 percent in 2002 and 2003, and by 7.9 percent in 2004. It reached parity with July 1998 (the pre-crash level) in July 2005. (World Bank (2005), \textit{Russian Economic Report}, no. 11, at www.worldbank.org.ru).

accounts for 25 percent of the country’s GDP,\textsuperscript{22} and this still does not take into account that much energy is sold domestically at prices below the world market level.

On a related track, there has also been much debate over the nature of the impact of the oil boom on Russian economic growth. While those who have been eager to project an image of ongoing diversification have played down the role of energy, many scholars have underlined precisely the opposite. Rudiger Ahrendt, for example, states as a “key finding” in a recent paper that “the role of the oil sector … has been vastly more important in driving economic growth from 2001 to 2004 than thus far recognized.”\textsuperscript{23}

Summing it all up, we may conclude that oil has been of paramount importance in transforming Russia. It is, however, not the mainly technical dimensions that have been laid out above that should draw our attention. Given what we know about the worldwide link between petropolitics and corruption, and about Russia’s own dismal history of corruption, the main impact of oil should be sought in the country’s political and business culture.

While Yukos was still the darling of Western investors, there were high hopes that inspired by the good example of Mikhail Khodorkovsky the Russian economy would finally come to be marked by transparency and good corporate governance. Following the destruction of Yukos, which brought home so clearly that the Kremlin’s political priorities will always trump commercial considerations, the example of Khodorkovsky conveys a completely different message. His simple bunk in a Siberian labor colony stands as a daily reminder of the country’s slide towards authoritarianism, and of the rising power of Putin’s new friends over the old class of oligarchs.

If we begin with the scourge of corruption, which over the past few years has been something of a leading theme in Russia watching, we may note that numerous reports on rampant and rising corruption have been associated not only with worrisome numbers on costs to the Russian economy. Towards the end of 2005, the disease of

\textsuperscript{22} What the World Bank analysts failed to note was that their job with Russian input-output tables had already been performed and presented by the Japanese scholar Masaki Kuboniwa (2002), “Hollowing Out Industrial production and Enlargement of Trade Sector in Russia’s Marketization,” paper presented to the AAASSS Annual Convention, Pittsburgh, PA, November 21-24. Credit is due.

dishonesty was also casting long shadows over the ability of Russia to lead the G8 in 2006. At stake here was whether Moscow would enjoy real rather than merely ceremonial membership in this the most prestigious of all the clubs of the rich.

Beginning already in the final year of Gorbachev’s rule, Russia had been welcome to join the cocktail and photo-op sessions but remained barred from the serious discussions between finance ministers that continued within the original G7. As he was preparing to take the helm, Putin no doubt was hoping that a successful Russian chairmanship would be crowned by the award of full membership. As the end of 2005 was approaching, however, things were turning sour.

On December 9, Transparency International, the Berlin-based non-profit anti-corruption watchdog, released its annual report on perceived corruption, where Russia had dropped to place 126 out of 159, representing Moscow’s lowest ranking since 2001. In a comment, it was said that “a steady increase in corruption and the lack of political will to fight it will present major obstacles as Russia assumes the G8 chair in 2006.” The fact that the release of this report coincided with the coming into force of the United Nations Convention Against Corruption may have served to highlight the issue even further, and the fact that Russia had been included on a newly released Failed States Index, albeit in place 59, added little comfort.

Turning to the slide towards authoritarianism, euphemistically known as “democratic backsliding,” moods towards the end of 2005 were further soured by critique against recent Russian legislation to curb the freedom of NGOs, and only days before the end of the year, Putin’s own maverick economic adviser, Andrei Illarionov, chose to announce his resignation, claiming that he could no longer work for a country that is not free. Having already branded the Kyoto Protocol as an “economic Auschwitz” and the Yukos affair as the “scam of the year,” he was prone to explain his resignation in customarily blunt words: “It is one thing to work in a country that is partly free. It is

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24 Other states to be found in the same bracket were Albania, Niger and Sierra Leone. The index listing may be downloaded from http://www1.transparency.org/cpi/2005/cpi2005_infocus.html.
26 The index may be found on www.fundforpeace.org.
another thing when the political system has changed, and the country has stopped being free and democratic. … I did not go to work for such a country.”

Then there was the gas crisis between Moscow and Kiev, which at once produced a torrent of renewed criticism against the Kremlin. In the US Congress, representative Tom Lantos introduced a bipartisan motion for Russia to be thrown out of the G8 altogether. He argued that allowing Moscow to take the presidency “is a profound gesture of hypocrisy because the G8 is made up of countries which are major industrial countries and political democracies,” and held that “The notion that Russia should be a member of this organization is absurd.”

While none of these represent problems that are to be taken lightly, it still remains a fact that in many important respects Russia under Putin is a world apart from Russia under Yeltsin. The main reasons for taking an upbeat view are that there is political stability and solid economic growth. This, however, not only constitutes a stark and highly encouraging contrast to the Yeltsin era. It also begs the question of how stability has been achieved, and what the implications may be.

In order to appreciate just how fundamental the ongoing transformation of the political landscape is, we shall digress briefly to note a few reasons why the Yeltsin-era oligarchy proved to be unsustainable.

**Failures of the Yeltsin Oligarchy**

The real essence of the system that emerged under Yeltsin was that of facilitating personal enrichment of the few at the expense of the many. While it is certainly true that there were frills of various kinds involved also for the Yeltsin family, frills that featured prominently in the investigations leading up to the “Skuratov Affair” in 1999-2000, the

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29 During Yevgeny Primakov’s brief tenure as prime minister, Prosecutor General Skuratov received a green light to join with Swiss prosecutors in investigating trails of corruption that led not only to the Kremlin but to the Yeltsin family itself. After Primakov’s removal, the investigations were blocked and eventually Skuratov was fired. As a parting gift, he provided the Russian Duma with a heap of compromising materials.
real reason why the Kremlin would choose to engage in such a basically venal compact was more likely related to power and glory.

Boris Yeltsin’s top priority, trumping all other ambitions, was to be recognized as a modern-day Russian Tsar, and to be treated with due respect. This was particularly worrisome for the very simple reason that it was so obviously a question of power for its own sake. In return for playing along with his blatant retrogression to tsarism, Yeltsin’s cronies were allowed to help themselves not only to the assets of the state but also to a steady inflow of foreign credits that were easily converted into stealable cash.

In order to appreciate why this represented such a tremendous deviation from Russian tradition, we must note that from the times of Muscovy and Peter the Great until the end of the Soviet Union the Russian state had served not only as the sole source of institutional change but also as the sole engine of growth. The stubborn refusal by the autocracy to allow any form of autonomous interest formation, or any form of initiative from below, placed a heavy imprint on economic development at large. Periods of rapid economic growth resulted from policies of forced mobilization from above, and periods of reform were driven by government programs that often were prompted by defeat in war (notably so in the cases of the Crimean war and the war against Japan).30

The achievements of Russia’s strategy of mobilization have been impressive indeed, defeating seemingly overwhelming enemies and transforming a small backward neck in the woods into a Great Power that for a brief period even played a role as a Superpower with global reach. The downside, however, is that the achievements of military might have come at a substantial price, to be measured in terms of a complete atrophy of all such institutions that promote and facilitate constructive and market friendly initiative from below.

We may illustrate the latter point by contrasting against Mancur Olson’s emphasis on the needs for “market-augmenting government,” more specifically defined as “a government powerful enough to create and protect property rights and to enforce contracts, yet constrained so as to not, by its own actions, deprive individuals of those

30 See further Hedlund, Stefan (2005), Russian Path Dependence, Routledge: London.
same rights.”  

The type of government that Olson sees as necessary for well functioning markets represents something of a diametric opposite to the type of rule that for centuries has been Russian normality.

While enforceable rights to private property will have to figure high on the list of what has been missing from Russian tradition, we must not forget some of the more subtle consequences that bound to be associated with a rule-evasive culture. Once actors realize that their actions are governed not by transparent rules but by the personal approval of their superiors, and that outcomes of those actions can thus not be predicted, neither in terms of rewards nor of penalties, they will then be simply compelled to engage in those types of opaque games of personal influence that have been – and still remain – so characteristic of Russian political culture. This in turn will also by necessity give rise to the phenomenon of massive and endemic corruption that was referred to above, and that also stands out as something of a dark hallmark of Russian tradition. What goes completely missing is the whole set of norms that make a functioning rules-based economy at all possible.

It is against precisely this background that we must view the Soviet collapse in 1991, which entailed not only territorial fragmentation but also mass looting of state assets. The parallel in Russian minds goes to both 1917, when the Russian empire collapsed, and to 1606 when the Muscovite state broke down. The implication in all three cases is that under an order that allows no initiative from below, the system as such is crucially dependent on having a strong central authority. If it breaks down, the system

32 Pipes, Richard (1974), *Russia under the Old Regime*, Charles Scribner’s Sons: New York, presents the fusion of power and property as the defining characteristic of Russia’s “patrimonial” regime.
33 Richard Hellie claims that this disease began in earnest in the Petrine era: “The process of corruption was slow, and made little headway (as far as I can tell) until the end of the reign of Peter the Great, who accelerated it when he neglected to pay many government officials.” (Hellie, Richard (2005), “The Structure of Russian Imperial History,” *History and Theory*, Theme Issue 44, December, p. 94.)
34 Adam Smith was well aware of this, and would likely not have been thrilled by the way in which his thinking was used to defend Russian greed-based shock therapeutic deregulation. To back this claim, it ought to be sufficient to recall the opening lines from the first great work by the Scottish moral philosopher: “How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it.” (Smith, Adam (1976), *Theory of Moral Sentiments*, Oxford: Clarendon Press).
breaks down. The ensuing freeing up of market forces will then be tantamount to mass plunder.

These observations provide the real key to understanding both the failures of the Yeltsin regime and the prospects for that of Putin. Coming out of a Soviet system where the interests of the state had always been placed above those of the population at large, the Yeltsin era did mark a radical new departure. For the first time in Russian history, it heralded an order where private interest was placed before the interests of the state.

This was most clearly visible in the realm of national security, where the Kremlin suddenly appeared as though there would never again be a need for major defense of the Motherland. If we accept that Russia’s economic growth strategy had been based, for centuries, on an ambition to enhance the country’s war-fighting capabilities by deploying a regime of forced mobilization of resources from above, this turn of events really was remarkable.

The decision that was taken by the Gaidar government in 1992, to undertake a sweeping cancellation of state orders to the famed military-industrial complex, then known in Russian as the voenno-promyshlennyi kompleks, or simply VPK, represented the first time ever that the Kremlin deliberately decided to disarm itself and to give up all hopes of maintaining armed parity with its enemies, real or imagined.

Knowing that the VPK had formed the real backbone of the Soviet economy, accounting for maybe 30 percent of recorded peacetime GDP,\(^{35}\) it should have come as no surprise that simply giving up on sustaining it would have far-reaching consequences. The most visible such was that over the years 1991-98, the output of the VPK dropped by more than 80 percent, leaving massive excess capacity.\(^{36}\) Less visible, but profoundly more important was the fact that in one fell swoop the state was deprived of effective control over the VPK. The combined effect of privatization and cancellation of state orders was that massive resources were suddenly put up for grabs.

\(^{35}\) There have been a number of various estimates presented over the years. This one is the latest, derived from prominent Russian insiders in positions to know. (Cited by Rosefielde, Steven (2002), “Back to the Future? Prospects for Russia’s Military-Industrial Revival,” Orbis, vol. 46, no. 3, pp. 505-06.)

In order to appreciate the full extent of the ensuing bonanza, we must note that the Soviet military doctrine had called for constant readiness to mobilize for multiple wars and all thinkable attack scenarios. The implication was that the Soviet government would maintain not only strategic reserves of the kinds that most nations stockpile. By placing an obligation on all enterprises within the VPK to be ready at short notice to surge the output of military materiel by numerous multiples it also called for the buildup and maintenance of special “mobilization reserves.” Included in the latter category were massive hoards of things like fuel and strategic metals, as well as whole production lines that were kept idle, just in case. This incredible waste of resources, which surely could have been put to better use, provides an impression of just how seriously the Soviet leadership took the matter of military preparedness.

The main outcome of Gaidar’s decision to scale down the VPK was that the ownership of all these assets was suddenly called into doubt. Under a guided policy of conversion and restructuring, controlled sales could have generated funds that might perhaps have been used to finance retooling and technological upgrading for civilian use. As it was, however, those who were in charge, and who no longer faced any effective control from above, were now given a de facto free rein to loot and to begin dumping metals on world markets. The magnitude of the operation could be clearly seen in a severe depression of prices on, say, the London Metal Exchange.

The very fact that this devastation appears to have come as a surprise to so many reflects an absence of insights into what the project of “transition” really implied. What economic analysts in general failed to consider, going beyond even Joseph Stiglitz’ severe critique, was under what conditions a free rein for short term profit and utility maximization will yield collectively rational outcomes, and when it will degenerate into a Hobbesian war of all against all. In his grand synthesis of the debates that ranged over

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38 Personal information from Vitaly Shlykov, who was head of the VPK under Boris Yeltsin.
39 As anecdotal evidence, we may note that for a few enchanted years so much metal passed through Estonia that this tiny country became one of the world’s leading exporters and the capital city came to be known as MeTallinn.
shock therapy versus gradualism, Gérard Roland places much emphasis on the implied belief in sure efficiency gains.\textsuperscript{41} Believers in the since so vilified Washington Consensus were quite simply convinced that a transition from grossly inefficient central planning to superior market economy could not fail but to result in improvement.

While there have since been many different reasons suggested to explain how and why \textit{all} transition economies would instead be thrown into “transformational recession,” the plight of Russia goes beyond such mainly technical reasoning. What Russia’s failed transition brings home is that under certain types of institutional arrangements, placing a wager on deregulation and a minimal state will be tantamount to courting disaster.

Viewed from this perspective, the system of oligarch-run business that became the true hallmark of the Yeltsin era had two vital defining characteristics, both of which stood in sharp contrast to all previous experience of Russian history.

One was that via different schemes of “privatization,” known in Russian as \textit{prikhvatisatsiya}, the country’s emerging class of new business tycoons were granted formal rights to property in some of the nation’s most valuable assets.\textsuperscript{42} The essence of this arrangement was that savvy operators were given \textit{carte blanche} to dispose of the usufruct, whilst remaining in complete uncertainty over whether tomorrow their formal “property rights” would have any value whatsoever. As the perceived main victim of their predation was a traditionally illegitimate state, mass looting quite simply was the rational strategy. As it used to be said under Stalin, “one who does not steal from the state, steals from his family.”

The second and perhaps even more lethal characteristic of the Yeltsin era, which the Chinese studiously avoided, was that of lifting all capital controls. By allowing the emerging oligarchs to cultivate good personal relations with foreign markets and foreign partners, the Kremlin served up on a gold platter amazing opportunities for the cronies of the regime to move their ill-gotten wealth to safe havens abroad. The outcome, unsurprisingly, was a flight of capital that would assume stunning proportions.\textsuperscript{43}

When Vladimir Putin was eased into his new Kremlin office, following Boris Yeltsin’s surprise resignation, he was looking at a landscape that was clearly reminiscent of scorched earth. Close to a decade of predatory capitalism, of the most rude and obscene form, had left devastating consequences, measured in a population meltdown, a ravaged system of higher education, and a spread of organized crime and corruption that was simply astounding. The challenge to the new president was to overcome this legacy, whilst remaining beholden to the man who had anointed him and who was ultimately responsible for the destruction.

The mainstay of Putin’s ambition to make Russia great again would rest in reversing both of these defining characteristics of the Yeltsin era, namely property rights and access to safe havens abroad. By resuming state control over what Lenin once referred to as the commanding heights of the economy, Putin made sure that the oligarchs would be aware that their rights to property were once again conditional upon service to the tsar, and that their options to run off to safe havens abroad would once again be effectively sealed off. The consequences again will be far-reaching.

In the following, we shall focus on the role of the energy complex as a powerhouse that is being purpose-built to support the Kremlin’s ambitions for a return of the Russian Federation to Great Power stature, and we shall portray Putin’s friends as a new class of boyars who are completely dependent on and thus beholden to their tsar.

**Resurrecting the Service State**

While Putin’s first term in office was still unfolding, there was a great deal of uncertainty over how to interpret the ambitions of the new master of the Kremlin. Following his re-election to a second term, and the conclusion of the Yukos affair, we can see with much greater clarity what is and has been going on. The essence of it all is fairly simple. The romance with Western models has come to an end, and the Kremlin is busy reverting to old Russian ways of doing things.


This should not be taken to mean that there is an ambition to revert to Communism or to the Soviet order. The new political class that is forming in and around the Kremlin has little interest indeed in regurgitating Marxism-Leninism, and it realizes fine well that there is nothing to be had from going back to the paraphernalia of state planning of the Gosplan kind. Putin’s program for making Russia great again is far more subtle, and in a sense more worrisome than that.

Perhaps the best way of portraying it is to borrow Richard Hellie’s notion of a Russian “service state,” a concept that entails imposing strict hierarchical bonds of allegiance and obedience. In his presentation, long-term Russian history has been marked by three cases of “service class revolutions” (under Ivan IV, Peter the Great and Joseph Stalin). The respective periods following upon these “revolutions” are concluded by “times of trouble” that path dependently lead up to a restoration of the old order. This metaphor is well in line with our model of forced mobilization from above, which leads cyclically to exhaustion, collapse and restoration of the status quo ante. The main question to be asked today is if Hellie is correct in speculating whether developments under Putin should be viewed as a “fourth service class revolution.”

By far the most important implication of presenting current developments against this backdrop is that it places in focus the traditional primacy, from Muscovy onwards, of opaque and personalized games of influence over transparent and enforceable rules of the game. There is nothing really remarkable about this. In a country that rests on the rule of men rather than on the rule of law, rules and regulations will always be trumped by personal friendships and loyalties. Russians know this fine well. It is the way that the game has been played for centuries, and they have amassed great skills in playing it.

Given their investments in human capital, and the associated evolution of norms and values to support this as a just and rational system, it was certainly to be expected that any ambition to undertake “systemic change” would encounter heavy resistance.

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46 This use of the notion of repeated “times of trouble” as interludes or punctuations between cycles of repression and liberalization is central also to Alexander Yanov’s theory on the origin and evolution of Russian autocracy. (Yanov, Alexander (1981), *The Origins of Autocracy: Ivan the Terrible in Russian History*, Berkeley and Los Angeles, CA: The University of California Press.) See especially his presentation of the “Political Spiral” (on pp. 59-65).
47 Hellie, 2005, op. cit., p. 112.
Transiting to an order that would be based on transparent and enforceable rules would have entailed a massive destruction both of human capital and of long-established networks of corruption. In consequence, it would thus also have implied a drastic shift in fortunes between the veterans of the old system and the rising stars of the new.

In an associated dimension, it was also logical that the transition from Yeltsin to Putin would mean a whole new set of friends being brought into the game. A closer look at the new guard that makes up Putin’s friends will show two important features, namely that they are almost all from the old KGB and that they are almost all in business. While the former adds an ominous shade to questions of democracy and human rights, the latter tells us much about how the game will continue to unfold. The business interests of Putin’s men have spread out of the energy complex, into transport, arms and metals. What they are busy creating may be viewed as a holding company that controls a steadily expanding share of Russian GDP, and that places massive slush funds at the Kremlin’s disposal.

At a casual glance one might be tempted to say that this was precisely what emerged with the oligarchs under Yeltsin, but that would miss the whole point of the argument. The crucial difference between Yeltsin’s oligarchs and Putin’s neo-boyars again lies in the two dimensions that were indicated above as hallmarks of the Yeltsin era, namely property rights and access to foreign friends. While some of the most favored amongst the new class of power holders will clearly be both wealthy and powerful, they will also be held in constant awareness of the fragility of their personal positions.

Where Yeltsin’s cronies had at least formal rights to property, and very real rights to move their wealth abroad, Putin’s men have neither. They control their assets only for as long as they please the Kremlin, and they have no safe places abroad where they would be welcome. Like the boyars of old Muscovy they will thus be completely dependent on their tsar – they have no personal property, and they are unable to enter into the service of another prince.

From this perspective, the present-day relation between President Vladimir Putin and ex-oligarch Boris Berezovsky may be viewed in terms similar to the classic relation

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48 For a detailed survey of the membership of Putin’s elite, and of the blurred line of demarcation between “liberals” and “siloviki,” see Kryshtanovskaya, Olga and Stephen White (2005), “Inside the Putin Court: A Research Note,” Europe-Asia Studies, vol. 57, no. 7.
between Grand Prince Ivan III and Prince Andrei Kurbskii, who fled Muscovy and entered in the service of Lithuania. Having betrayed their respective masters, both become apostate and faced life-long exile.

The first practical challenge that faced President Putin was to reverse all those formal steps towards democracy and a rules-based economy that had been taken under Yeltsin, and that might over time have come to be imbued also with the culture of democracy and of the rule of law. In a sense, his agenda might be likened to what Lenin set out to do after Great October. In its final decades, the Russian Empire had been moving clearly in the direction of Westernization; suffice it here to recall the legal reforms of Alexander II, the Basic Law of 1906, the general elections to a new Duma, the land reform under Stolypin, and the emerging class of urban merchants. After 1917, all of this was to be swiftly and deliberately eradicated.

What both examples illustrate is that formal changes in the rules will have the desired effects, and achieve sustainability, only if they are accompanied by a supporting transformation of associated norms and values, and the latter, as Douglass North emphatically drives home, will occur only gradually.49 The hotly debated question of whether in its final decades the Russian Empire really was about to join Europe hinges on precisely this, namely on whether informal norms – public as well as private – were being adjusted to fit and support the new set of Western rules and practices. If at the time of Great October this still appeared doubtful, despite several decades of fundamental reforms, then it should be quite clear that less than a decade of Yeltsinite chaos and confusion stood an even slimmer chance of achieving real and sustainable institutional change. Support for the counter-proposition, namely that Russian norms and values have remained overwhelmingly alien to the Western way, seems so much easier to find.

It is both striking and ominous that Putin’s carefully balanced policy of cautiously rehabilitating Joseph Stalin, whilst adhering to the principles of market-based globalization, entails so many features that find a great deal of support amongst the Russian population at large. A quick look at recent opinion polls will tell us that Russians overwhelmingly feel that democracy is a fraud, that private property is façade for

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corruption, and that outsiders are not to be trusted. They feel comfortable with a one-party state, place order before freedom, and have little problem with censorship of the media. Above all, they want Russia to be a great power again, and they see more government involvement in the country’s economic life as a way to reach that goal.\(^{50}\) Putin is set to deliver on all counts.

At the core of his ambition to make Russia great again we may find the country’s energy complex.\(^{51}\) We may recall here what was said on preceding pages about how oil and gas are being used to construct an economic powerhouse, on the foundations of which a new system of political power may be built. While most pundits were still debating the seeming irrationality of the Kremlin’s onslaught against Yukos, the crown jewel of the country’s oil industry, some perceptive analysts could already see clearly the long-term political rationality. Peter Lavelle, for example, saw Putin being rationally “determined to re-order Russia’s oil patch to serve national and international interests.”\(^{52}\)

Following the conclusion of the Yukos “affair,” we can see the contours of the new powerhouse. At its core are two energy giants. One is state-owned Rosneft, which following the absorption of Yuganskneftegaz has emerged as Russia’s second largest oil company. The other is Gazprom, whose known reserves (measured in barrels of oil equivalents) are the third largest in the world, and whose daily output of gas equals 10.3 million barrels of oil.\(^{53}\) Although often at odds with each other, both are firmly under Kremlin control and together they provide a formidable boost to foreign policy.

It is already well known how the energy weapon has been wielded within the CIS, to boost Russian influence in what the Kremlin likes to call its “near abroad.” To this may be added that Putin’s recent foreign travels have been heavily linked to energy. And there was the “gas crisis” between Moscow and Kiev. And, of course, we have the sordid story of Schroeder, the EU, and the Russian-German gas pipeline that many Poles view as a new Molotov-Ribbentrop Pact.


\(^{51}\) Vladimir Shlapentokh captures this when he writes about “Russia as a Newborn Superpower: Putin as the Lord of Oil and Gas,” on *Johnson’s Russia List*, February 9, 2006, item 18.


The bottom line, however, is concerned with so much more than just foreign energy policy, or even with simply putting cash into the pockets of a new set of cronies. What is really at stake is a complete reconfiguration of domestic power. What we are presently witnessing is the formation of a new boyar duma, an elite group of men who control the commanding heights of both the economy and the political sphere. Like the boyars of old, and in stark contrast to Yeltsin’s oligarchs, they will be completely dependent on, and thus unconditionally loyal to their tsar.

Although we can witness how their influence is expanding into sectors outside the energy complex, the exact nature of their roles and activities will remain opaque. While crucially needed patronage from the tsar will remain forever in doubt, their own informal power over subordinates will be vastly greater than their formal positions indicate. As all and sundry will soon enough comprehend, one simply does not mess with a boyar who has the ear of the tsar.

This, in conclusion, appears to be the real and lasting outcome of shock therapy and attempted systemic change – a return to traditional Muscovite games of neglasnost and of vicious infighting over seats close to the tsar, coupled with remuneration for “service” that takes place via a host of informal and clandestine channels. The Russian Federation will surely continue projecting an image of modernity and globalization, and foreign audiences will be playing along. It is all part of the game. Behind the façade, however, Kremlin rules again will be those of old Russia rather than of modern Europe.

This outcome is certainly not all bad. It may well be supportive of high economic growth, based on proven methods of state controlled mobilization from above, and it does enjoy wide popularity amongst Russians. If we think in terms of democracy and human rights, however, it certainly does not bode well for the future. Could it have panned out differently, with different advisors and a different policy from the West? Perhaps, and hopefully Yes, but that is a question that shall never receive a clear-cut answer.

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