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THE ENIGMA OF RUSSIA

The economy is booming. But is the country really changing?

BY PAUL STAROBIN

It seems Boris Berezovsky was right. The mercurial, trouble-prone Russian oligarch, who fled Moscow for London in the fall of 2000 to avoid arrest on theft charges, last summer invited me to fly over for lunch at his regular Savile Row haunt. As his bodyguards discreetly ate their lamb chops at a nearby table, Berezovsky explained why his nemesis, the get-tough regime of Russian President Vladimir V. Putin, was such bad news. In Russia, he warned, there is no such thing as a golden mean. Everything is taken to an extreme. "There are no internal limits," he pronounced. No brakes.

At the time, I discounted his warning—which seemed both self-serving and, well, extreme. After all, Russia seemed to be on the rebound after Putin took over for a sclerotic Boris N. Yeltsin on New Year's Day, 2000. The economy was rapidly expanding after tanking in the August, 1998, financial crisis. Polls showed ordinary Russians to be more hopeful than ever. And my favorite opti-

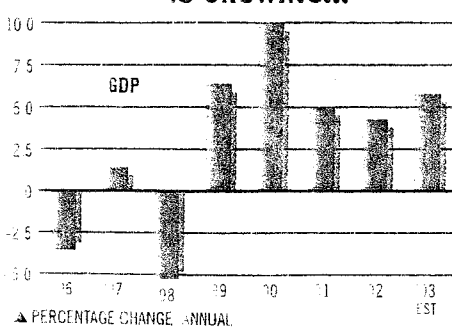
mism indicator, the birthrate, which had fallen off sharply in the dark 1990s, was inching up again. Finally, it seemed, Mother Russia was back on her feet, pushing around baby strollers.

But as my four-year tour as Moscow bureau chief for *BusinessWeek* comes to a close, Berezovsky is looking alarmingly prescient. In a balance-sheet reckoning of a place I love, my head isn't buying what my heart wants to sell. The Yeltsin era, which began brightly, with historic reforms to free Russia from Soviet controls on property and the media but descended into a chaotic sinkhole of corruption, surely was in need of a corrective. But the control-oriented Putin regime is failing to get the balance right. Yeltsin's flawed but genuine liberal impulse is being supplanted by a gathering authoritarian push as the ex-KGB agents and other law-enforcement

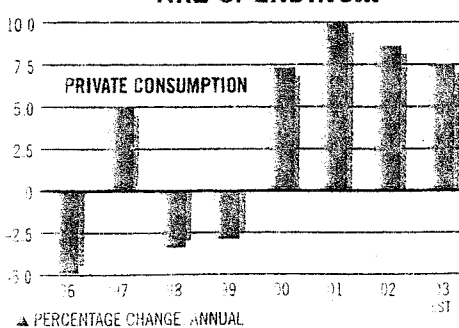


The Good News

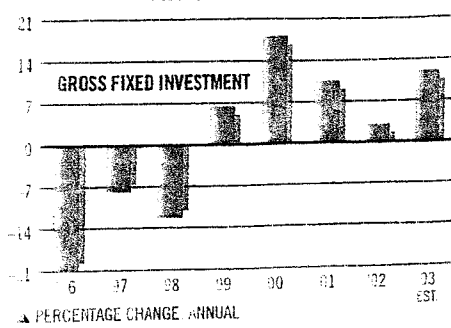
THE ECONOMY IS GROWING...



...CONSUMERS ARE SPENDING...



...AND COMPANIES ARE INVESTING



The crackdown on oligarch Khodorkovsky has deeply alarmed business and foreign investors

officials Putin has worked with for most of his career—the *siloviki*, or “men of power”—become more confident of their grip on the Kremlin and key ministries.

The *siloviki* have taken increasingly brazen steps over the last few months to ensure that they keep their power. Russia is gearing up for parliamentary elections in December and presidential elections in March. If Putin goes, they go, too. So the *siloviki* seem determined to quash potential opposition—if necessary, by threatening the property of those deemed enemies. In June, the Kremlin press ministry pulled the plug on the last privately owned national TV network, replacing it with a sports channel.

Then, in early July, in a move that has rocked Russia Inc. and foreign investors, the country's richest man, oil baron Mikhail Khodorkovsky, suddenly found his business empire under siege. His main partner was arrested and detained on property theft charges related to a fertilizer company privatization in 1994 and the prosecutors opened investigations into the murders of business and political figures with whom Khodorkovsky's oil company, Yukos, clashed in the late 1990s. The trigger for this legal barrage, it appears, was Khodorkovsky's stated intention to bankroll pro-Western liberal parties the Putin camp views as a threat to its plan to dominate the next Parliament with pro-Kremlin factions.

Putin & Co. deny a political motivation. A Putin aide says that the particular Yukos-related legal cases are being independently pursued by the federal prosecutor's office with Putin himself being kept informed of developments but

not acting as “the trigger” for the actions. The aide denies the moves were timed to elections—but does portray them as part of Putin's top-priority effort to protect Russian society by building a strong state. “In general, the President is demanding more active work of the *siloviki* in order to ensure that the laws of this country are obeyed,” the aide says. “In the last decade, during the 1990s, there was chaos, and the *siloviki* were not doing their job properly.” The aide also suggested that Yukos had failed to pay sufficient taxes over the past five years, a charge that a Yukos spokesman hotly denied.

Surely, Khodorkovsky is no angel, but what investors find so worrisome—the Russian stock market has plummeted 15% since the arrest on July 2 of Khodorkovsky's partner, Platon Lebedev—is the apparent political manipulation of the judicial process. Without secure property rights protected by independent courts, Russia's market economy faces a bleak future. “If you look at what Putin says he wants to achieve—a doubling of gross domestic product and a sizable place in the world economy—you're not going to get there by behaving like this,” says Stephen O'Sullivan, co-head of research at Moscow investment bank United Financial Group.

As Lebedev sits in the same prison, Lefortovo, where the KGB once detained political prisoners such as Natan Sharansky, Khodorkovsky, just back from a trip to Washington, is frantically bidding for support from the Bush Administration. His company, Yukos, has won praise from Western politicians and in-

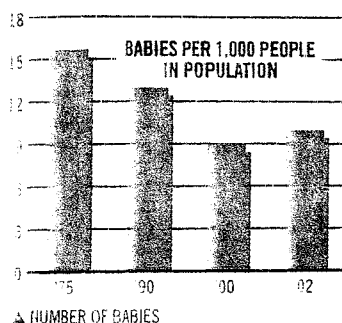
vestors for its ahead-of-the-pack efforts to improve corporate governance and for Khodorkovsky's advocacy of a close U.S.-Russia strategic partnership built on the flow of Russian oil to the U.S. But the Bush Administration seems reluctant to risk Putin's ire by intervening.

In an hour-long interview at his Yukos headquarters in Moscow on July 21, I found a relaxed Khodorkovsky, clad in a dark-grey polo shirt, closely inspecting a small desk clock sent to him as a gift by the Russian state-owned daily *Rossiiskaya Gazeta*. Just checking for hidden microphones, he joked. Then he got serious. “What we've got in this case is an excess of enthusiasm” on the part of hard-liners in the law-enforcement establishment, he says. “They don't like Big Business and especially independent Big Business—and they feel it's their job to put it in its place.” He's resting his hopes for an end to the siege on a meeting with Putin himself. “The only place I can go to complain is the President,” Khodorkovsky says. The stakes, in his view, are high. “If we continue hounding rich people and kicking them out of the country,” he says, “we will not move far from our primordial cave.”

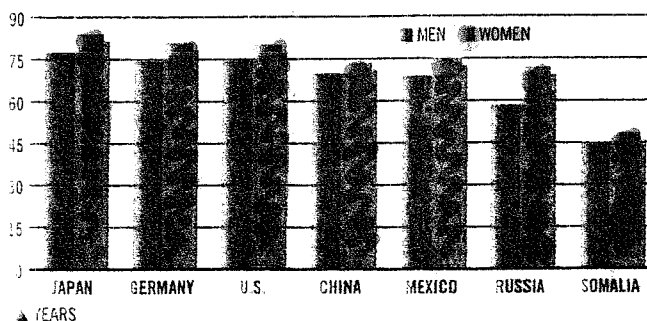
Putin supporters view the legal case being mounted against Khodorkovsky's empire as part of a necessary and continuing campaign to purge Russia of robber-baron capitalism and create more favorable conditions for steady growth. “Putin is making a decision to encourage honest capitalism,” Valeri N. Velichko, a 25-year veteran of the KGB and a consultant to its successor, the Federal Security Service (FSB), told me in an interview at his Moscow quarters, from

The Bad News

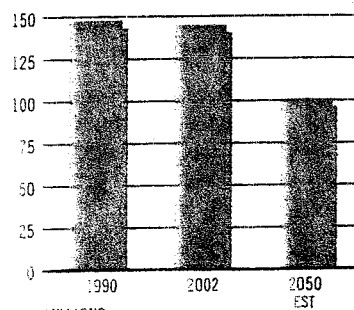
THE BIRTH RATE IS LOW...



...LIFE EXPECTANCY IS SHORT...



...AND THE POPULATION IS DECLINING

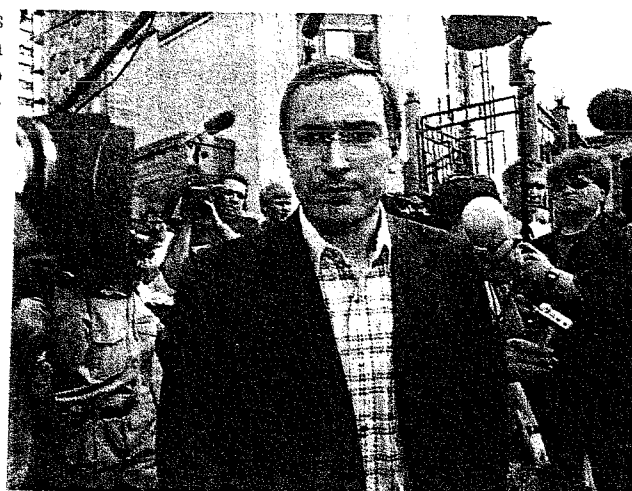


The Kremlin
distr...

which he runs a club of ex-KGB officials. He predicts more such actions aimed at oligarchs who control strategic natural resources. "Of course" Putin is behind this campaign, Velichko adds. "Putin is not a half-drunk Yeltsin, and he is not a person here for a short time. He is interested in long-term projects to restore Russia." At the end of the interview, Velichko presented me with a gift calendar displaying portraits of his hero, Felix Dzerzhinsky, the founder of the Soviet secret police.

It is still not clear how far this authoritarian swing-back will go. But Russian history shows that these periods of reaction can be harsh and tend to last a long time—much longer than the liberal reforms that periodically break out (table). In this case, Team Putin is ending a relatively long Russian spring that began before Yeltsin, in the *perestroika* and *glasnost* reforms launched by Mikhail Gorbachev in the mid-1980s.

To be sure, Putin's team has much to be proud of. Five years after the Aug. 17, 1998, ruble crash, the economy has rebounded briskly. GDP is expected to grow 5.8% this year, vs. 2.3% in the U.S. and 0.7% in Europe. The ruble is strong, foreign exchange reserves are a robust \$68 billion, and the trade surplus is swelling. Violent, Yeltsin-era clashes between the Kremlin and Parliament are a fading memory. "To have political and economic stability is a very good thing," says Alexander M. Branis, di-



UNDER FIRE Are Khodorkovsky's liberal politics the real target?

rector of Moscow-based investment fund Prosperity Capital Management Ltd. He cites as helpful such Putin reforms as the launch of

a flat income tax.

But the progress achieved by the Putin regime threatens to be undone by the *siloviki*. An outright renationalization of assets seems unlikely, as the Putin team knows oligarchs tend to manage large business organizations more efficiently than the state can. But it's possible that "enemy" oligarchs could be pressured to sell their assets to politically acquiescent ones with tight ties to the *siloviki*. "This is the redistribution of property by one clan, using law-enforcement agencies," says the liberal member of Parliament Irina Khakamada.

On one level, the country seems to be lapsing into pre-Revolutionary times, when private business proceeded at the

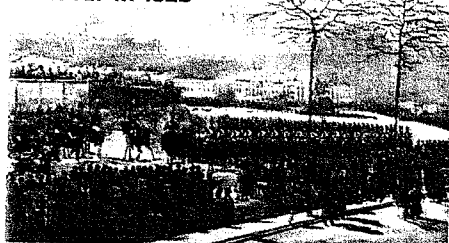
sufferance of the Kremlin and efforts to build a strong state to guard against anarchy became all-consuming and destructive ventures in their own right.

How did post-Soviet Russia get to this point? It's a complicated tale, about not just the Putin clan and its ambitions but also a traumatized society's need for a paternalistic figure. Most ordinary Russians, after an initial euphoria over the collapse of the Soviet regime, came to see themselves as not free but abandoned. Many viewed the last Soviet leader, Gorbachev, as a traitor, and many turned on Yeltsin as weak and feckless because he permitted a new group of predatory wolves, the oligarchs, to rob Mother Russia by making off with her oil fields, gold mines, and other wealth in rigged privatization auctions. Russians' main desire was not democracy but order.

In this context, Putin, the slim, trim, black-belt in judo—a man who had spent his entire career in law enforcement—appeared as a rescuer. "There is a sort of psychological need in Russia for a protective state, and Putin is providing that," says the U.S. Ambassador to Russia Alexander Vershbow. Last summer, for example, one hit song was titled *Someone Like Putin*, in which a teenage girl compares her layabout boyfriend unfavorably to the ramrod-straight President. And as alarming as the Yukos affair is to investors concerned about property rights, ordinary Russians are enjoying the spectacle of an oligarch's head in a vise and would undoubtedly

Russia's Vicious Cycle: Reform Followed by Reaction

THE DECEMBRIST REVOLT IN 1825



REFORM

1812-25

French Enlightenment spurs formation of secret anti-Czarist society of liberal aristocrats, the Decembrists.

REACTION

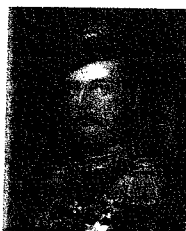
1825-55

A putsch attempt by the Decembrists is crushed by Czar Nicholas I, who establishes a new police-state regime

REFORM

1855-81

Czar Alexander II frees the serfs in 1861, the highlight of a reform wave that spans his entire rule.

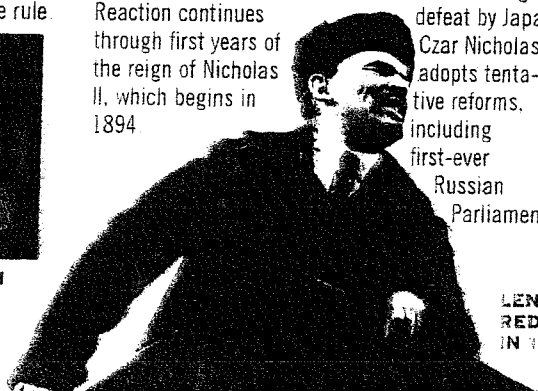


ALEXANDER II

REACTION

1882-1904

Alexander II killed by revolutionaries, spurring crackdown by successor Alexander III. Reaction continues through first years of the reign of Nicholas II, which begins in 1894.



LENIN IN RED SQUARE IN 1918

REFORM

1905-17

Following workers' bloody uprising in St. Petersburg and Russia's humiliating defeat by Japan, Czar Nicholas II adopts tentative reforms, including first-ever Russian Parliament.

REACTION

1917-53

After October revolution Bolsheviks establish Cheka secret police to crush rival factions. In 1935, Josef Stalin launches the Great Terror, bloodily purging ranks of political and military Establishment to consolidate his dictatorial rule. Reaction continues until his death in 1953.

The KGB men Putin surrounds himself with seem to distrust the open society needed for economic growth

support a wider crackdown: A recent independent poll by the ROMIR Group found that nearly 80% favor revising the 1990s privatizations, with nearly 90% saying they believe the tycoons acquired their fortunes illegally.

Most Russians view Putin's paternalistic approach favorably. Economic circumstances, after all, have truly improved in many regions, not just in Moscow. Just before the Khodorkovsky furor began, I took a drive down to Kaluga, a typical central Russian provincial city some 125 miles south of Moscow on the Oka River. Things are looking up. Vladimir Kondukov, the 48-year-old doctor who has run Kaluga's city health department since 1995, told me. Kaluga's Soviet-era defense industry collapsed in the early 1990s. Things got so bad that ration cards were distributed to locals for food. But now, a private economy has sprung up that includes a thriving beer brewery and a farm machinery maker. Since 1998, the city's health budget has tripled, from \$3 million to \$9 million. "The worst is over," Kondukov told me.

From his office at City Hall, I headed to the *rod dom*—the local maternity house, a grey Soviet-era building tucked away in a leafy patch of town. Kaluga is participating in Russia's mini-boom in babies, and Yelena Kruchilina's story seems typical. A 28-year-old lawyer, she has been married for six years but didn't feel ready for children until she and her husband, Andrei, a chauffeur, had saved enough to provide for a family.

Now, she'll be going home with baby Danila to a new apartment, bought for \$10,500 with some help from her parents. What's next? "We plan to have another child as soon as the doctor allows me," she says.

Arguably, Putin's top-down model for development has also provided succor to Russia's poorest regions. Under Yeltsin's loose rule, many regional governors took over Soviet-era businesses for themselves and refused to countenance competitors. The Putin team cracked down with a new law making it easier for the Kremlin to remove bad governors, then urged big Moscow oligarchs to help the poorest provinces.

No one outdid the philanthropic campaign, eccentric and grandiose even by Russian standards, mounted by oil and aluminum baron Roman A. Abramovich. In December, 2000, he won election as governor of the province of Chukotka, across the Bering Strait from Alaska, a forbidding land of reindeer and frozen tundra whose mostly unemployed 70,000 people suffered from tuberculosis and malnutrition. On a visit there during a frigid week in February, I found a staggering array of public-works projects under way, including a new electricity plant, schools, hospitals, a subsidized helicopter-transportation service, a Western-style supermarket, a Dolby-sound movie theater, an indoor hockey rink, and an English-style pub. The locals were grateful but puzzled. "Maybe the governor wants [us] to live like people live in Alaska," ventured

Gennadi Baiborodov, general director of the local airline, ChukotAvia.

Back in Moscow, Abramovich told me he's paying for virtually all of these ventures out of his own pocket, to the tune of \$200 million a year. But he has decided that his first term as governor will be his last. Shifting his focus to Great Britain, Abramovich recently bought Chelsea Football Club for \$100 million. That has angered some in the Putin clan, who apparently view it as unpatriotic. In any case, there still is little private enterprise in Chukotka. Unless its people find a new benefactor, they may again find themselves shivering through the long, dark winters of the Arctic North.

The weakness of the Team Putin approach is also apparent in the crew's reluctance to proceed with market-oriented reforms that would benefit the economy but reduce their ability to manipulate strategic businesses for political ends. Gazprom, the bloated, state-controlled gas monopoly, is not being broken up, as liberal reformers had hoped. Instead, with Alexei Miller, a Putin loyalist, at the helm, it increasingly is being used to get former Soviet republics who still depend on Russia for their gas supplies to maintain allegiance to Moscow.

A key objective is the restoration of Russian influence in the Caucasus and Central Asia, where Moscow aims to counter Washington's growing clout. Under Defense Minister Sergei Ivanov, another of the men who worked with Putin in the KGB, Russia is building a new base in one

REFORM



1985-99

Mikhail Gorbachev launches bold reforms, leading to the collapse of the USSR in 1991. Later Boris Yeltsin privatizes state property and frees the media. His regime is engulfed by corruption after '96

2000-03

On Jan. 1, 2000, ex-KGB Colonel Vladimir Putin takes over for ailing Yeltsin and consolidates his power with a clan of security-service buddies. After his election in March, his regime limits governors' powers and intimidates press with arrest of Kremlin critic Vladimir Gusinsky and forced self-

off of Gusinsky's NTV television station to state-controlled



SHUTTERED TV STATION

REACTION

Gazprom. Gusinsky goes into exile, as does another prominent Putin critic, Boris Berezovsky.

2003

March: In a Kremlin-ordered election widely seen as rigged, 96% of Chechens are officially declared to have approved a new constitution making the

breakaway republic a part of Russia.

June: Putin's press ministry pulls the plug on TVS, Russia's last remaining privately owned national television network.

July: With parliamentary elections approaching in December, the business empire

of titan Mikhail Khodorkovsky, a prime financial supporter of liberal political parties, is targeted by federal prosecutors. His partner is arrested and detained and his Yukos oil company's offices are raided.

Data: *BusinessWeek*
PRESIDENT PUTIN VOTING IN 2000



International Business

gas-dependent republic. Kyrgyzstan, and reinforcing one in Armenia.

Notwithstanding Putin's pragmatic desire for cooperative relations with Washington, the siloviki intensely distrust America. They are envious of U.S. technological and economic prowess but disdainful of, or perhaps just puzzled by, America's political philosophy—they just don't seem to get that liberal values are essential to creating an open society in which business and science can thrive. Putin's camp believes in "enlightened autocracy," says ex-KGB agent Velichko. Among the fraternity of Russian security-service officers, the KGB is in fact an elite, patriotic calling, which traces its roots back to Czar Nicholas I, who in 1825 created "the higher police" in his effort to modernize Russia at a disciplined pace. Westerners may see the KGB crowd as thugs, but many, Putin included, have professional degrees (he's a lawyer by training) and pride themselves on their understanding of statecraft. Yet they have an inbred mistrust of democracy, and this mindset makes unlikely a genuine compatibility, a lasting, deep alliance, between the Russia of the Putin regime and America and other Western countries. Overall, "Russia seems more similar to our culture than it really is," notes U.S. Ambassador Vershbow. "There is this whole shadow world in the corridors of power."

So the Putin crew controls defense policy. It has the oligarchs mostly whipped and the media under control. There are still liberal reformers left in the government, but their influence appears to be diminishing. But there's one force Putin's team may not be able to control: demographics.

You might think economic growth would be making Russians healthier. But apart from the modest rise in the birthrate and a slight decline in infant mortality, there is little sign of this so far. Since 1998, life expectancy for men has actually declined, from 61.3 years to 58.5.

The big problem is—you guessed it—vodka. It's sometimes said that Russians, and particularly Russian men, hinge on the bottle as a path to oblivion for relief from the general misery of life. But data indicate that Russians drink when times are bad—and they drink even more when times get better.



PAST AND FUTURE Many Russians find Putin's paternalism comforting

Last year, a time of prosperity, Russian vodka production rose 7% over 2001's, to 1.4 billion liters, the highest in eight years. Widespread alcoholism

brings death in numerous ways—heart disease, car accidents, violent brawling. Excessive drinking and other bodily abuse is a kind of cultural legacy in Russia, as Yevgeny Andreyev, a mathematician at the Russian Academy of Sciences, sees it—the result of live-for-today attitudes formed by the experience of so many calamities.

Thus, the death rate in Russia is nearly twice the birthrate—17 Russians die for every 10 who are born. Grimmer still, the World Bank is predicting that an AIDS epidemic will strike Russia in 2005-2010 as a result of what is already a major spread of HIV infection, the precursor to AIDS. If AIDS is not brought under control, the government's own, hardly sunny, forecast—a 30% decline from today's 145 million people, to 101 million by 2050—could prove overly optimistic. "The numbers are mind-boggling," says demographer Murray Feshbach at the Woodrow Wilson International Center for Scholars in Washington. Left unchecked, the spread of AIDS could have "a devastating long-term effect on the stability of health and pension systems" in Russia, warns the World Bank. Private savings would have to be diverted into AIDS treatment, potentially reducing GDP by 4.15% by 2010 and 10.5% by 2010. Investment would decline even more, says the World Bank.

Although Putin is citing the need to combat AIDS, drug abuse, and related health problems, they are not getting much funding. Even with budget coffers, swelled by oil-export revenues, running a surplus of 1.2% of GDP, the federal government is lagging well behind the West, with total health expenditures of 3.8% of GDP, compared with 8.4%, on average, for the 30 industrialized countries belonging to the Organization for Economic Cooperation & Development. What's being missed is an opportunity to break with history in the creation of a healthier, more modern, less brutal Russia. If the country is determined to adopt a centralized, paternalistic model for its development, then at least the leaders should be paternalists in the best sense, applying not

just firm discipline to the bad actors but providing nurturing care to everyone else. But that's not happening. So while the control freaks at the Kremlin fixate on expanding the apparatus of the state, the society around them is in danger of shriveling.

Russia, you are a heartbreaker. But if your state is callous and terrifying, your people, and many of their traditions, are sweet and poignant. On a recent Saturday, I boarded the Tolstoy Express, a train that leaves Kursky railway station in Moscow for Yasnaya Polyana, Tolstoy's country estate in the Tula region, just south of Kaluga. Hallowed ground for the writer's worshippers, Yasnaya Polyana also is a place of pilgrimage for just-marrieds who take celebratory strolls along footpaths bordered by apple orchards and white birches.

I arrived on an unseasonably cold and windy day. Shivering in their thin white gowns, the brides draped over their bare shoulders the dark suit jackets handed over by their husbands—on this one day, at least, models of chivalry. Friends snapped pictures and uncorked champagne for toasts to the happiness of the newlyweds, *za schastye maladych*. Tolstoy, who never stopped believing in Russia even as he railed against its multitudinous faults, would surely be pleased.

BusinessWeek online

For an extensive interview with
Khodorkovsky, go to
www.businessweek.com/magazine/extra.htm