

Appendix to Section 3.3:

Some anecdotal evidence of outsider entrepreneurs' integration into the oligarchic system

As mentioned in the main text, the Soviet ownership system had been administered based on the relationship of political patronage, and while the collapse of the Soviet Union opened up opportunities for outsider oligarchs to enter the scene, the situation in which political and insider connections defined the control over most of the physical capital inherited from the planned economy could not and did not change overnight. Campos and Giovannoni (2006) show that the transitional environment generated huge incentives to “strip” those insider-controlled assets, and many outsider oligarchs as well as insider oligarchs who had made their initial fortunes in newly created commercial banks indeed actively participated in such asset stripping. The resulting story of the emergence and consolidation of the new oligarchic system during President Yeltsin's second term in office (1996-1999) has been told through anecdotal evidence by many sources (see, for example, Klebnikov, 2000; Black et al., 2002). To supplement our quantitative analysis in Section 3.3 here we review the main storyline.

The first big chance for adept outsider oligarchs to square up against members of the old *nomenklatura* elite with regard to ownership of most lucrative tangible assets of the former Soviet economy came on the verge of the first Presidential election after the collapse of communism. In late 1995 – early 1996, Yeltsin's popularity was at a historic low and the communist party seemed to have a real chance of regaining power. The outsider oligarchs who had made fortunes in the banking sector deployed this wealth (in particular by actively buying influence over the country's media) to turn the tide of the presidential campaign. Reelected to the second term, President Yeltsin rewarded his most active political supporters by allowing them to greatly speed up the process of large-scale asset reallocation in their favor, punctuated by a number of high-level political appointments. Thus, Vladimir Potanin (the leader of the Oneximbank group) became first deputy Prime-Minister, while Boris Berezovsky was appointed deputy chairman of the powerful Security Council. The new government appointed by Yeltsin in early 1997 was led by reformist politicians with even closer ties to outsider oligarchs.

A number of insider oligarchs, especially red directors, who tried to maintain independent control of the assets they inherited from the Soviet era found themselves

expropriated. For example, Victor Paliy had been general director of a big oil development in Tyumen region since 1989 and held on to it under the name of Tyumen Oil Company (TNK). In 1997 he lost control of his business to the consortium of two outsider oligarchic groups, Alpha and Renova, led by Mikhail Fridman and Victor Vekselberg. Mr. Paliy refused to go away peacefully, so he was also criminally charged and prosecuted. In another instance, Anatoly Filatov who had worked at Norilsk Nickel, the largest producer of nickel in Europe since 1957 and had been its general director since the Soviet era, was fired from his position in 1996, shortly after the oligarchic group led by the Mr. Potanin won control over the factory in one of the infamous “loans for shares” auctions. In these auctions widely believed to be completely rigged, government shares in a number of major companies in primary resources and telecommunication sectors were basically given away to just a few oligarchic groups that had developed special relationships with the polity. Among those hand-picked winners we find both insider (Lukoil, Surgut and Oneximbank) and outsider oligarchic groups (the Berezovsky-Abramovich and Khodorkovsky groups). Klebnikov (2000, Chapter 7) describes the loans-for-share auctions in more detail (see also Guriev and Rachinsky, 2005). The financial meltdown of 1998 cost several former *nomeklatura* bankers their positions as their banks were declared bankrupt while profitable assets were transferred to other banks, controlled by outsider oligarchs. The meltdown of 1998 also resulted in expropriations of a few outsider banking oligarchs, but most of them came out of the crisis stronger than before.

The old Soviet-era oligarchy was also forced to share its control over productive assets with new members coming from the ranks of reformer politicians. One of the earliest examples was Pyotr Aven, the first post-communist minister of Foreign Economic Relations, who left the government in 1993 to become a senior partner in the newly emerging oligarchic group Alpha. This process greatly accelerated during President Yeltsin’s second term in office. For example, when Boris Nemtsov became first deputy Prime-Minister in Yeltsin’s “young reformers” government in 1997, he pushed through the appointment of his crony, Boris Brevnov, a small banker from the provincial city of Nizhny Novgorod, to the all-important position of the Chairman of the United Energy System (UES), the Russian utility monopoly, which until then had been

run by its former “red director”. Mr. Brevnov’s stint at the helm of the UES was short-lived but his replacement was Anatoly Chubais, “the architect of Russian privatization” who also brought in a number of his political allies and personal aides with him. Overall, 28 oligarchs in our sample came from former reformist politicians and their close personal assistants, and 11 more oligarchs represent political hirings by private oligarchic groups of former politicians who were not necessarily among the leading reformers but who nevertheless possessed significant political clout (such as former members of the Presidential administration, governors, mayors, and their relatives and aides).

The frequently-cited story of Boris Berezovsky’s business empire (see, for example, Klebnikov, 2000) contains in a nutshell stories of evolution of many of what initially promised to be pioneering new businesses. Mr. Berezovsky started with a small team comprised mostly of mathematicians specializing in automated systems, but he also recruited an influential member of an ethnic mob from the outset. His business took off after he joined forces with Vladimir Kadannikov, the red director of AutoVAZ, the largest car manufacturer in Russia. The newly formed partnership launched the “Logovaz” company in 1989, hailed at the time as “the first western-style car dealership” in the Soviet Union. In reality, it was more of a simple price arbitrage scheme, in which the factory sold its cars to the dealership at government-regulated prices, and the dealership resold those at much higher market prices. Mr. Berezovsky then marketed an investment fund promising to build “the first people’s car” in Russia that turned out to be a trivial Ponzi scheme and promptly collapsed. Mr. Berezovsky, however, went on to become a media mogul by taking control of the first channel of Russian television, and he used loans-for-shares auctions to acquire Sibneft oil company. His infamous personal relationship with President Yeltsin’s family made him the most powerful Russian oligarch of his time.

Similarly, Roman Abramovich, the richest Russian oligarch as of 2005, began his career in a small toy-producing cooperative where he was not even the owner but rather a hired manager. His career, which is somewhat obscure at that point, might have turned around when his reported personal acquaintance with Andrey Gorodilov, son of the red director of what later became Sibneft oil company, caught Mr. Berezovsky’s attention. Mr. Gorodilov-senior agreed to peacefully transfer control over the company to Messrs.

Berezovsky and Abramovich, and, in return, Mr. Gorodilov-junior was appointed to a senior managerial position. In yet one more example, Alexei Mordashov, a freshly mint MBA from a British University, started his career at the age of 28 as he was hired by the red director of the Cherepovets steel factory, one of the largest steel producers in Russia, to become his financial guru. Mr. Mordashov then pushed through a privatization scheme that resulted in transferring control over the factory to a newly formed Severostal company where Mr. Mordashov owned 51 per cent of the shares. The red director who, according to his own subsequent interview, failed to understand the importance of this one extra per cent, was forced to retire and Mr. Mordashov has since emerged as the oligarch in sole control of one of the largest steel companies in Russia.

Outsider oligarchs also frequently worked together with politicians and/or government bureaucrats in positions to directly channel flows of government money. For example, in 1993 President Yeltsin created government-funded State Investment Corporation (Gosinkor) with the official aim of investing in strategically important projects. Mr. Yeltsin's former chief of staff, Yuri Petrov was appointed to head the new corporation but instead of investing in rebuilding strategically important industries, he channeled the government-provided funds to a privately owned holding group Guta, which used it to finance its business acquisitions, particularly in confectionery industry. Do we need to mention that Mr. Petrov's son became one of the senior managers of the Guta group? In yet another example, the Inteco company owned by Yelena Baturina has grown into the largest construction company in Russia courtesy of the political clout of her husband, Yuri Luzhkov, the powerful Mayor of Moscow. Mr. Luzhkov himself was repeatedly picked up in expert ratings used by us as one of the most influential businessmen in the land despite never formally owning any business.

While the extent of this asset-stripping and rent-seeking was indeed, “[o]ne of the least pleasant surprises of the transition from centrally planned to market economy” (Campos and Giovannoni, 2006, p. 681), two observations are in order here. First, even if outsider oligarchs made use of opportunities to engage in those activities, the basic environment that made them lucrative had been created long before them. (Arkady Vaksberg, the investigative journalist with life-time experience of studying and exposing “the Soviet Mafia”, dates its emergence back to the 1960s (Vaksberg, 1991).) Second, in

what might be considered a surprisingly large number of exceptions to the rule, outsider oligarchs have been able to grow their businesses without developing ostensible special relationships with either insider oligarchs, or the state, or the mob. For example, Ruben Vardanyan started his career in 1990 as a hired manager for Dialog bank, one of the first joint ventures with foreign capital participation in the banking sector in the former Soviet Union. In 1991 he borrowed \$35,000 from Dialog bank to start his own investment company called “Troika Dialog”. Ten years after that, “Troika Dialog” with Mr. Vardanyan at its helm emerged as the largest and most successful investment bank in Russia. In other examples, the already-mentioned Svyatoslav Fyodorov became one of the major players not only on the economic but also on the political scene by simply continuing to run his microsurgery of the eye business, while Kakha Bendukidze transformed a number of old engineering factories including the Soviet industrial giant Uralmash into profitable market-oriented companies.