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A CONFUSING TURN IN RUSSIA:
DOES KHODORKOVSKY'S ARREST SIGNAL A RETREAT:
FROM ECONOMIC REFORM?

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QUESTION & ANSWER SESSION

P R O C E E D I N G S

MR. NESSEN: Good morning. I am obviously not Jim Steinberg. Jim is detained at another appointment, and he hopes to get here as soon as possible. He hopes to get here and take part before we conclude. I'm Ron Nessen, and I'll be your moderator until Jim arrives.

The topic of this morning's briefing is, "Does Khodorkovsky's Arrest Signal a Retreat from Economic Reform in Russia?" Also, we will certainly touch on the political effects of the arrest, the effects on U.S.-Russian relations, and it would be hard to ignore the headlines in the newspaper and not talk a little bit about events in the past few days in Georgia.

Our panel today are, first of all, Cliff Gaddy, who is a senior fellow in both the Foreign Policy Studies and Governance Studies program here at Brookings; Fiona Hill, senior fellow in the Foreign Policy Studies program; and Z. Blake Marshall, who is the executive vice president of the U.S.-Russia Business Council, which represents about 300 American companies who operate in the Russian market.

I should say that a lot of the information that will be discussed today is in a new book that Cliff and Fiona have written called, "The Siberian Curse: How Communist Planners Left Russia Out in the Cold," the effects of such a large portion of the Russian population and economy being based in the colder parts of the country without proper transportation, and communication and so forth. The book is just out. It is on sale at the Brookings' book shop, and I think we're offering a 20-percent discount today.

The complete bios of our panel members are in the packets outside. In case you didn't get one, you can pick one up, and it gives you a much greater detail about our backgrounds.

So we're going to begin our briefing. We're going to have brief opening statements from our three panel members, we'll have some discussion among the panel, and then we'll take questions from the audience.

And we'll begin the presentations with Cliff Gaddy.

MR. GADDY: Thanks very much, Ron.

If you permit me, I would like to make a few comments that situate the general topic of today's discussion—the current events in Russia around the YUKOS and Khodorkovsky affair—in the context of some of the ideas that Fiona and I have developed in our book. And it may appear, as I begin, the connection may seem tenuous. I hope to make that connection more concrete when I conclude my remarks, and I think Fiona will also elaborate on this, but I did want to present the basic thesis of our book. It's really based on a few simple, but we think generally underappreciated, concepts.

We all know, by now, and we should have known earlier, the irrationality and the inefficiency of the Soviet economic system, the old Soviet economic system of central planning. We know that by failing to allow or even consciously preventing individuals from expressing their free choices in consumption and production, this system ended up by building factories that produced the wrong things in the wrong way. It educated people to participate in that system, educating them for the wrong things--of

course, all relative to what a natural development might have been, a normal market system would have produced.

But what I want to stress is the point that we make in the book. Not only did it build these factories to produce the wrong things in the wrong way, it built the factories in the wrong places, and it moved people there to work in these factories.

We argue that this spatial, territorial, geographical element is vitally important in recognizing the damage done by the system of Communist central planning. The system was clearly monumentally inefficient and irrational. It lasted a long time, but the generally underappreciated point, we think, is that it was a system that operated on a uniquely large and cold territory.

There was, as we say in the book, unprecedented room for error. It made for the worst-possible scenario for--to use the vernacular--screwing up a country's economy.

We had, number one, an ideology of peopling, populating, and also industrializing and urbanizing spaces that free people voluntarily would not move to;

Two, a political system that could coerce them to move anyway;

Third, an economic system that could not recognize how costly this was once it had been accomplished; and,

Fourth, lots of time and lots of space to pursue this folly.

In the book, we try to quantify some of this. We examine, in particular, the cities that were built in these remote and cold places. The book is full of facts, it's full of figures, it's full of charts. I'm not going to repeat all of that or try to, but let me just give you one factoid--there's lots of facts and factoids in the book as well. It's

something that at least I think Americans can perhaps understand when we bring up the issue of Alaska.

The United States, Americans, we have a big chunk of cold territory, don't we? We have Alaska. It's about 20 percent as big as the continental United States. Now, imagine this. If we were to look at all of the cities in North America and Russia--North America, including Canada, and Russia--look at all of the cities with populations of over 100,000 people, take those cities and then rank them from the coldest to the warmest. The first Alaskan city on that list would not come until No. 135. There would be 112 Russian cities ahead on that list, ahead of Anchorage, Alaska, would be the city.

So, I see, Alaska is not really that cold? Is that the conclusion? Not at all. It's very cold. The point is we just don't build big cities there, and the punch line is really, yes, Anchorage, Alaska, is No. 135 on that list. Anchorage, Alaska, is the only Alaskan city on the list. There's only one Alaskan city over 100,000 people.

We call the cost--and that's what we argue, that there is a cost to having cities in cold places, and we deal a lot with this issue--we call this cost a cold and distance tax for Russia. Distance is an issue that we examine separately--a cold and distance tax. Of course, this is not really a tax in the conventional sense. It's not a tax that transfers resources to be used elsewhere. Tax is not a good term in that regard because this is pure waste.

How big is the waste? We conservatively estimate that the cold alone, not even taking into account the remoteness of these places and the difficulty of providing for transportation, and connections, and communications otherwise, the cold alone, the cost of having so many people in this cold territory, may be costing today's

Russia around 2 percentage points of GDP per year, 2 percent a year. In as short a time as 15 years, this cold tax alone would therefore eat up as much as 75 percent of growth.

Another point is that the spatial misallocation of resources may be the most enduring of all of the misallocations of the Soviet system, and this point relates to the notion that cities or--and I use the term loosely, to some extent, in the Russian case because there are urban agglomerations that look an awful lot like cities, but that don't really have some fundamental features in common with Western cities in other parts of the world--but cities are enduring entities. It is very difficult to get rid of cities once they are there. It is even difficult to shrink them.

Now, in our U.S. experience, we think we know something about shrinking cities. We think we know about cities that have declined in population, but, in fact, what we're generally talking about is cases where urban centers may shrink. Populations, however, remain in the same general metro area, the same urban agglomeration, moving to the suburbs.

Our only real experience with true shrinkage of cities is in smaller towns and villages that have been shocked by industrial failure or shocked by changing market conditions in, for instance, steel or mining or textiles, and these cities of 25- or, at most, 30-, 40,000 people may shrink, and there are a few cases in which they have actually disappeared.

But of big cities, the changes are still relatively modest. These big cities have the ability to adjust, and diversify and persist. So changing and reducing the size of these populations, especially the large cities in these cold and remote regions, is very difficult. And yet the fundamental point is that if the spatial misallocation is part of the

legacy of nonmarket allocation of economic resources in the Russian economy, it needs to be changed to achieve a true market system.

You cannot have, we argue, market reform, full-fledged market reform, without changing the territorial structure of Russia. And, finally, we show that this is not yet happening, at least not on the scale necessary. And, again, we do some quantification of this. We look how the movement of population of Russia, since 1990-'91, to warmer areas--and it has been happening, to some extent--to what extent is this really changing the territorial structure? Is it really warming the country in an economic sense?

I won't go through the details, but the bottom line is that at current rates in the last few years, it will take about 100 years to reverse the damage done, to get rid of this cold tax.

Our answer, not a prescription, but our answer is that what has to happen for Russia to become a true market economy and become efficient is that it has to shrink its enormous space. It has to shrink its space economically, not territorially. We're not saying that Russia has to divest itself of its cold and remote territories. They will remain part of Russia. Siberia will remain part of Russia in the same way that Canada's Northern territories remain part of Canada or that Alaska remains part of the United States. But Russia, as a whole, will become economically warmer and closer to markets.

So, to summarize the points from our book, misallocation, we say, was an essential feature of the irrationality and inefficiency of the Soviet system, not just a byproduct, but an essential feature;

Second, this spatial aspect of the misallocation is extremely costly;

Third, it is also enduring. It is extremely difficult to change. Cities just don't shrink. That is a very disruptive process and, in general, the key phrase might be that reallocation means dislocation--massive dislocation.

And this brings me, very briefly, to today's Russia. What I have just described to you I think is critical to understanding what Fiona and I have called "Putin's dilemma." Mr. Putin came into office with two mandates or imperatives, partially self-imposed, but these two imperatives are irreconcilable fundamentally.

The first of these imperatives for Mr. Putin is to improve the efficiency of the Russian economy. It has to become a competitive economy, able to stand in the world, in the globalized economy. Mr. Putin knows that the old Soviet system was inefficient. I don't think he knows why it was inefficient. He knows it was inefficient because it lost the competition. As he would say, "life showed us that we lost."

His second imperative, however, is to ensure stability in this country, to prevent, as he has repeatedly said, the fragmentation, the disintegration, the collapse of Russia. And what Fiona and I argue in the book is that that first imperative--efficiency--can only come by shrinking Russia's territory economically, by moving capital and labor back to where it was before the Russian revolution to the warmer, Western regions of European Russia. The economy cannot become a full-fledged market economy otherwise. But as I said, relocation means dislocation.

This will not happen without allowing mobility, and in fact allowing it is not enough. Encouraging mobility, perhaps that may not be enough--essentially, pushing people to be mobile. And this will mean, inevitably, massive change,

revolutionary change. It will mean disruption, dislocation, it will mean instability, violating therefore the second imperative.

There is right now, it appears, another one of these "who lost Russia" debates, sometimes implicitly, sometimes explicitly. We see the headlines. Some people seem shocked that there is an apparent new Putin, not the one they thought was there before. I don't believe there is a new Putin. I think that this is the same Putin, the same individual faced with the same fundamental dilemma that I just described, but that what is happening and what is new is that he is increasingly facing a new reality, a reality engendered by the Russia that he and all Russians inherited from the Soviet past.

The windfall of the high world oil prices and the positive effect of the 1998 devaluation, allowed him to square the circle, to avoid the fundamental dilemma and contradictions of stability versus economic change and fundamental reform for a while, but the squeeze has gradually risen, it has come, and that this is ultimately what is producing the current conflict.

MS. HILL: I will try to make a segue from where Clifford just stopped. That was a little abrupt, actually. I wasn't quite expecting him to end there. But anyway, I'm going to pick up on this question about whether Russia is now on a road to authoritarianism and was the arrest of Mikhail Khodorkovsky some kind of turning point, which was one of the issues that we used to frame today's discussion.

As Clifford just ended his exposition there, I would argue that what Putin is doing today, in terms of squeezing civil society, arresting people like Mikhail Khodorkovsky and really moving or, I would say, continuing in this line of political pressure is, frankly, what Yeltsin would have liked to have done before him.

And what many of the leaders in the broad region of the former Soviet Union would also like to do--and were, in fact, trying to do, especially in places like Central Asia, in terms of consolidating state power and creating a hierarchical strong state, with the president at the top of the totem pole. In fact, what we're seeing with today's Putin is a direct continuation of the Yeltsin era. This is not something that was newly invented by President Putin.

Yeltsin put all of the building blocks in place for an authoritarian system, beginning back in the 1990s, especially with his 1993 Constitution, which when you combine that with the bombing of the Russian Parliament building back in October 1993, just over 10 years ago, laid the groundwork for a really hyper-centralized presidency in Russia. And you could say even that Yeltsin invented "gunboat" democracy, not just the managed democracy that we see with Putin today, (which is the title of another Brookings book that we have outside.)

So it was Yeltsin who began the push to emasculate the political parties in Russia, beginning, of course, with the Communist Party and his squeeze on that party through successive elections in the Russian Parliament.

It was Yeltsin who also created a party of power, and it was Yeltsin who then stated that the president of Russia does not need to have a party. In fact, he put the president above the political party fray and made the president of Russia accountable only to public opinion, which has played out very well for Putin, though, we know that it didn't play out so well for Yeltsin himself.

It was also Yeltsin who put a lot of the former KGB officials, the so-called "Siloviki," who everyone loves to talk about today, in place in state structures and

also in private business. And, we have to remember that one of those KGB officials, both former and active, that was elevated to the supreme position, Vladimir Putin, was placed in the position of prime minister by Yeltsin himself.

Yeltsin also reinvented and reinvigorated Kremlinology. It was he who started the endless intrigues within the presidential apparatus and really made "divide and rule" an art in the last few years of his presidency.

Of course, we are also accusing Putin of excesses in Chechnya, but remember it was Yeltsin who started the first war in Chechnya and gave a nod to the second war, when Putin was prime minister, that also helped Putin secure the presidency. So the point of that is that it was Yeltsin who created all of the structures for a strong state. This fact was noted by many analysts in the mid-1990s. You can go back and look at many articles and find all of the people who have been talking about this sudden new turn for Putin were talking about these same problems with Yeltsin a few years ago.

So the question is why then didn't Yeltsin behave in the way that Putin is now? Well, the fact is Yeltsin couldn't capitalize on the structures he put in place simply because he didn't have the capital. He didn't have the hard cash. He couldn't use the state to rein everything back in again, including the regions of Russia or any of the political parties, and that's why he had to strike the initial deals with oligarchs back in the 1990s in the privatization schemes to actually bring some money into the state coffers to try to get the state into some kind of shape.

And Yeltsin lost popularity precisely because he didn't have the cash and because the state was weak because he couldn't pay people's wages, he couldn't pay

pensioners' pensions, and he couldn't make the state deliver anything for the Russian people in that period.

Now, that was the case until the devaluation of the ruble in 1998 and then, as Cliff mentioned, the rapid rise in world oil prices. We forget that, towards the end of the 1990s, world oil prices were only at about \$10 a barrel, and there was a dramatic change in 1999-2000 with the world oil price rising to as much as \$40 a barrel.

Russia, as a result of this starvation of revenues, back when oil prices were low, was a supplicant to the West for aid, as well as to its own robber barons.

Now, the situation changed very dramatically just as Putin was coming into office, first, as prime minister, then as president. I just want to show you a quick visual aid here. I don't know if people can see it at the back. This is a little handy chart that Cliff made a while ago. You see this big spike here. This is a spike of growth in the Russian economy, and it is precisely, at this point, that Putin comes into place, just as growth was taking off after the devaluation of the ruble and with the rise in world oil prices.

So the economy basically spiked just as Putin came into power, and suddenly he was able to do everything that Yeltsin had not been able to do, in terms of restoring what he refers to as the "vertical of power," which is putting the president and the state back at the top of the political system in Russia at the expense of Russia's regions and of civil society.

And most importantly, Putin could do what Yeltsin could not do, in terms of making the state deliver, paying people's salaries, paying pensions, and also, very importantly, paying off Russia's debts. Russia no longer needs handouts from the West.

So, today, what we see in Russia is a state that's been bolstered to, in many respects, by energy revenues, and I would argue that this is actually at the expense of civil society. In fact, Russia has become almost a classic petro-state, in terms of its strengthening on the back of high world oil prices. And just to put this into perspective again, about one-third of Russian budget revenues come from oil and gas.

Now, you can see this quite clearly if you make a quick comparison with Georgia. If you'll just permit me, I'll move south for a moment just to try to illustrate really what's been happening in Russia.

In Georgia, the state has been continually starved of revenues for the last decade. Shevardnadze could never pay any bills whatsoever, including salaries for key institutions like the military and the police, which we'll see faded away over the last week in terms of their support for him. The state was indebted to everybody. And Shevardnadze's popularity, just like Yeltsin's in the 1990s, faded very quickly, along with the loss of confidence in the state.

Shevardnadze was never able to deliver anything. And in stark contrast to Russia, Georgia has no natural resources. There was never any revenues coming in for oil and gas, and there were no oligarchs to prop up the state. Shevardnadze couldn't basically borrow from his robber barons in the way that Yeltsin did.

Those doing business in Georgia were always doing everything out of the sight of the state in the shadow economy, avoiding paying taxes. And, in fact, civil society strengthened itself at the expense of the state. In fact, the irony is that, in Georgia, opposition parties were able to raise money from their members and also from the business community and NGOs could apply to people like George Soros or the U.S.

State Department or the Eurasia Foundation or the British Government and the EU for grants. Shevardnadze couldn't really do that.

So we had a strange situation, where nongovernmental organizations were better financed than the state in Georgia, as we saw with spectacular results. Civil society prevailed over the state in Georgia, leading to those stunning developments and Shevardnadze's resignation.

A similar thing might have happened in the 1990s in Russia. We saw a burgeoning of political parties like Yabloko, SPS and the other liberal parties. We saw a real activation of nongovernmental organizations. We saw civil society protest the first war in Chechnya, but then the tide changed in 1998-1999 with the sudden influx of money from oil and gas into the state coffers.

Although Yeltsin was able to pick his successor and quash his opposition at the very end of his presidency, we see, in contrast, that Shevardnadze was never able to do that.

So, in Russia, in very stark contrast with Georgia, the state has now strengthened itself at the expense of civil society and the flood of petro-dollars into the Russian economy far outweighs any of the grants to NGOs or political parties. And Putin's popularity has risen with the cash revenues coming into the state, bolstering his position and popularity with the public.

As a result of the strengthening of the state, political parties find it very hard now to present alternatives to Putinism because really what can they offer? If you look at the party of power in Russia today, Yedinstvo (Unity), the party that is most

likely to prevail in the upcoming parliamentary elections, what it really promises to the people is kind of the glory of the Soviet past in a more efficient, market-oriented form.

If you contrast that with the Communist Party, there's actually not much of a contrast. The Communist Party is offering people nostalgia for the Soviet past, but not perhaps this kind of more efficient, market-oriented Russia. And then the liberal parties, Yabloko and SPS, that had done very well in the 1990s by offering an alternative to the old Soviet state, in terms of a shift towards Western institutions, have been denigrated, in many respects, by what happened in the 1990s.

People now associate the West and Western institutions in Russia with shock therapy and with a disastrous economic reform which, from the popular level, really just resulted in the fact that no one had their pensions and no one had their wages paid. And at this particular point, as we know, Russia's relations with the West are so much better than they've been in the past. It's very difficult for parties like Yabloko or SPS to really offer something new to the Russian public, and they are also cash poor. They have had a very hard time in maintaining their funding.

So this brings me to a poster with three eternal Russian questions that I also want to use as a visual aid. This was published by a publication called, "Economics in Life," just after the crash of the ruble in 1998. And it says here in Russian the three eternal Russian questions: "Who is guilty?" "What shall we do?" And "Where's the money?"

Now, this third one I think is the most important, "Where is the money?" In fact, it helps to provide answers to the other two, especially in the case of Mikhail Khodorkovsky because where was the money? Mikhail Khodorkovsky had the money.

He had a lot of money. He had \$8 billion in his personal fortune alone, and that means of course, in response to the question, "Who was guilty?" well, obviously, Mikhail Khodorkovsky was guilty.

And then as a response to, "What to do?" he has the money and he's guilty, well, arrest him. That's, of course, in a very simplistic form, but I think there's an important point here because Khodorkovsky was a threat to the state in many respects precisely because he was an alternative source of money. He in his financing of civil society was pulling a kind of a George Soros or the kind of thing that one has seen unfolding in Georgia where civil society has strengthened itself at the expense of the state. But more importantly, he could really influence economic policy within Russia at the expense of the state.

And Khodorkovsky was very successful at lobbying the Duma, the Russian Parliament, spreading money around to all kinds of political parties, including the Communists, to effectively change critical energy sector legislation in his favor and also tax legislation. He was out to make as much money as possible in as quick a time as possible, and his whole strategy as a businessman was to maximize oil output, which was a pretty logical strategy, but also to exploit as many tax loop holes as possible, and to reduce corporate taxes so he didn't have to pay quite as much money to the state. He also was not pursuing the development of the energy sector in the way that the state would have wanted, in terms of choosing projects in difficult areas that the state had deemed a priority or in terms of boosting the state's revenues, given the importance of energy revenues to the state.

Some analysts have recently calculated that Khodorkovsky's various tax havens that he used by exploiting these loop holes and by lobbying the Duma, might have cost the Russian Government as much as \$2 billion in lost revenue, and that was at the same time that he managed to boost YUKOS's, his company's, own oil production from just under 900,000 barrels per day in 1999 to 1.4 million barrels per day in 2002. So you can see that if he was paying less revenues to the state, he was obviously bringing in a lot more to himself.

And this is important because, although, as I mentioned, Putin came in on the crest of a wave of economic growth, as Cliff made clear in his presentation at the beginning, that's begun to taper off. Oil prices have obviously dropped from that all-time high of \$40 a barrel down to the upper \$20s, although they're not anywhere near where they were in the late 1990s of \$10 a barrel.

But given all of the persistent challenges of sustaining growth and building a viable economy in Russia that we outline in the book, "The Siberian Curse," and with the pot shrinking, Putin, as the head of the state, couldn't afford to have too much money flowing out into private hands where he couldn't really control it.

So it was fine when everyone was flush with money around 2000 to let Khodorkovsky make as much as he wanted, but once the belt had to tighten, then, unfortunately, that belt turned into a noose tightening around Khodorkovsky's neck. There's been a push for perhaps the last two years in Moscow to really try to tax the energy sector much more, to bring in more Russian energy revenues to the budget just as there's been pressure on the Russian Government to move ahead with reforms in other sectors, to find ways of boosting all of those industries stuck out in cold places into

Siberia, and to provide investment capital for other priority projects. It's really only from the energy sector that the Russian state is going to get the money.

There was a recent assessment in Russia by Putin's staff of how much capital was actually controlled by Putin or the state, either directly or indirectly. And this assessment showed that there was much more outside of the state's purview, in the hands of people like Khodorkovsky, than perhaps was comfortable for the state when it was thinking about how to manage democracy or how to kick-start moribund sectors of the economy or, just simply how to keeping the existing economy, and all of the problems that Cliff mentioned, afloat and try to make things just a little bit more efficient.

In sum here, energy is the main game for Russia, and I think Blake is going to talk a little bit more about this from the investment side. The state is really dependent on energy for its budget revenues to subsidize the domestic economy and, in many respects, energy for Russia is like the fix for an addict. The state really does need oil revenues to strengthen itself, and the question is how long can it go on without taking more drastic steps to restructure the economy to reduce this dependence on Russian energy.

So, domestically in Russia, there is some kind of rhyme and reason to the seeming madness that we've seen over the last few months. Although from the outside, for all of us, of course, Russia seems much more unpredictable as a result of Putin's flexing the state's muscles.

And the government, I think, will now keep moving in this direction that Putin has begun in terms of trying to increase the flow of revenues to the state and away

from people like Khodorkovsky. I think we are likely to see moves towards lifting the current caps on export duties, revisiting the issue of licenses for oil companies doing business in Russia. This will obviously be of considerable importance to Western investors, especially major U.S. and international oil companies.

I guess the question that hopefully Blake will try to address is how much can the Russian state get away with before there becomes a kind of a revolt from the West in terms of investment and also before this has some kind of impact on U.S.-Russia relations, and now Jim is here, and maybe we can let him make some comment on that, too.

MR. MARSHALL: Thanks, Fiona. I think that's a convenient segue for me to pick up the thread and talk a bit about the economic impact of the YUKOS affair and the Khodorkovsky arrest and the response, the undercurrents, that we're sensing at the U.S.-Russia Business Council within the foreign investor community and, to a lesser degree, within the Russian investor community, and I'll talk a bit about that as well.

Let me start, just from the outset, with a little caveat of sorts. We, at the Council, don't profess to have a crystal ball to be able to look in the future and discern exactly how this is all going to play out or exactly what this is all about in the current day, what the stakes are and the state of play in the YUKOS affair.

Having said that, we are monitoring the situation very, very closely. It is, however, not uncommon in the Russian scene for these sorts of situations to feature more questions than answers, and that's certainly the case today with respect to the YUKOS affair.

In order to set up my remarks, let me return to one of the baseline questions that Ron posed at the outset, and that is to what extent does the Khodorkovsky arrest and the YUKOS affair signal perhaps a retreat from Russian economic reform? I think probably not is my take on that, and I'll come back and explain why that is the case.

Let me rephrase the question and then pose it in the following manner:

Could this, though, signal a retreat from the response to Russian economic reform; that is, the credit gained by the Russian state for the policy initiatives that they are undertaking? Well, maybe, and let's pick that apart and see how it plays out.

There are several aspects, several facets to the business community response that help us sort of assess and identify precisely what are their concerns with respect to the Khodorkovsky affair.

First, and not surprisingly, rule of law issues, and that is to say businesses want to see evolve in the Russian marketplace a rule of law that is transparent and predictable versus the rule of man that is somewhat arbitrary and unpredictable.

Secondly, and related, uncertainty. It's the enemy of all investors, foreign or domestic. And the uncertainty in this case is fed by the selective prosecution of Mr. Khodorkovsky and the lack of clarity that has been emanating from the Russian Government to identify precisely what this case is and is not about.

At various moments, when there seems to be an overwhelmingly negative response from the investor community, the Russian Government has come out and tried to calm the waters, and issued statements, and done basically a good job with that. And

the biggest example that we've seen in the past several weeks was, of course, the Kremlin meeting at which President Putin spoke with members of the banking and investment banking community, and that was a success, by all accounts. That seemed to lay all of the cards on the table, and address their concerns, and have questions answered over a two-hour period. That is very important because it's been missing from the equation from the outset.

Third, property rights. That's really the fundamental issue at stake here. That's really what this is all about at the end of the day for the business community. The main focus of this uncertainty has to do with, if you are a follow-on investor coming into the Russian marketplace, you want some guarantee of your title insurance. If you're thinking about a strategic partnership with a Russian enterprise, you want to know that net present value in 2003 counts for something, not the origins of the privatization in 1995. So, if they're going to revisit these privatizations, well, fine, maybe they can have a Russian national discourse on that subject, but they need to let the foreign investor community know that at the very outset.

Fourth, due process, and this is not the purview of the investor community per se, but it's safe to say that businesses are taken aback by some of the prosecutorial abuses that we've seen unfold from the general prosecutor's offices, and we can go into some detail in the Q&A, if you'd like, on that score.

And then, fifth and finally, what I would loosely term "collateral damage," and that is to say that raids on orphanages do not enhance the investment image of a country of an emerging market. And, similarly, removing the databases from Yabloko's PR firm is a potentially a very negative consequence that could have some

long-term impact, and investors, that is not on the business community, especially as we approach the December parliamentary elections.

So let me return to one of the fundamental undercurrents and one of the main questions that investors have been grappling with since early July when Platon Lebedev was arrested, but more so in the past month since the October 25th arrest of Mr. Khodorkovsky himself, and that is to what extent is this about Mikhail Khodorkovsky, the person, the oligarch, and therefore politics and big-picture, high-stakes, high-flying politics, for example, versus YUKOS, the enterprise?

Is this about Khodorkovsky, and, therefore, if he's locked up, if he's tried and run through the due process in the Russian court system, will this be over? Is it an isolated event? Is it under control? Or is it more about YUKOS and pipeline politics and the energy sector in the Russian marketplace and is there some segment of the Russian elite that wouldn't mind seeing the YUKOS empire disassembled?

I think, on that score, the jury is still out, and we have actually vacillated and gone back and forth about which trajectory this was likely to take over the past couple of months. There have been some very positive signs, such as the August approval of the YUKOS-Sibneft merger. That seemed to calm the business community and give everyone confidence that this was not primarily about YUKOS, that it was high personalized and directed mainly at Mr. Khodorkovsky himself.

But since that time, of course, we've seen some other contradictory signals that have given us a little bit of a wobble on those that have primarily to do with the licensing investigations into YUKOS' assets, into fields in Khanty-Mansiysk and in

Yamal Nenets, and this is also an example of the lack of clarity about what precisely is transpiring.

For instance, there was an uproar within the investment community about going to pull these licenses, and examine the performance on the licenses, and potentially remove the fields from YUKOS' operation. That would have very dramatic impact on the marketplace, so much so that President Putin sensed the need to speak publicly on this score while on a foreign trip in Italy. So it's risen to that level, that you have to make a public presidential comment while abroad in order to calm the marketplace, and he said absolutely the right things. He said this would be unwise and state organs should not be used in this manner.

Well, that worked for a week or so, and then the Ministry of Natural Resources continued this campaign to open up the books and go through several dozen licenses that are under YUKOS's control. And anyone who's operated in the energy sector knows very well that this is a natural occurrence, that licenses are routinely examined for performance obligations, and if you aren't meeting them, you run the risk of having your license pulled.

I'm not sure that the volume of the current license investigation or the little snippets that we're hearing about how this procedure is unfolding is the norm, and that's where clarity and clarification from the Russian Government is very important. So President Putin has disavowed this investigation and said now is not really a good time for this to take place, yet it continues, and it continues--our reading at least--in some respect at the behest of the General Prosecutor's Office. So this is a check-and-balance kind of equation that investors are trying to figure out.

And, thirdly, and finally, on another contradictory signal that just emerged last week is the opening officially of a tax-evasion investigation into Sibneft, which of course is one big piece of the merger, of the merged entity YUKOS-Sibneft, creating Russia's largest oil company.

That has given investors pause, and we'd like to see exactly, very clearly and transparently, what this is and is not all about because it does add fuel to the fire if people want to spin out this notion of disassembling the YUKOS empire. It feeds into scenarios--I don't buy into it myself, necessarily, but there are those observers out there who believe that the Russian state has, and this gets back to some of Fiona's comments about exerting economic influence and about state control, it does have a desire to have a Russian state-owned major on the scene as a major player in the marketplace, and so there are those observers in the energy sector who think, well, pieces of YUKOS, pieces of Sibneft, add that to Rosneft, add that to Surgut, and all of a sudden you have a major player on the world stage, rivaling Gazprom and the natural gas sector and that that is one slice of what this is all about.

So that kind of leaves the investor community to wonder about the notion that was posited last week in an editorial just a few days ago in Vedomosti, the highly regarded Russian financial newspaper, which posited that the war with YUKOS is turning into a war with the oil industry. Clearly, if that is the case, and there is not clarity on this question, that would have a very negative dramatic impact on markets overall.

Let me talk, then, a bit about the impact that we're sensing today, both in terms of direct and indirect impact. This is, admittedly, very difficult to quantify. It's

not scientific. It is largely anecdotal. The only scientific measure we have and here the cause-and-effect linkages are not exactly clear, is capital flight. And one common-sense rational judgment about third-quarter capital flight is to say that after impressive net inflows in the first half of this year, especially in the second quarter of this year, we saw a reversal, a very dramatic reversal in that trend in the third quarter, with billions of dollars headed out of Russia, such that the revised forecast now is a net deficit, capital flight of predicted \$13 billion by December 31st, when Russia could well have been headed in the direction of posting a net inflow again this year, and there are no seasonal factors to account for this.

So it's left to your inference, but clearly markets were rattled, and capital flight in the third quarter was one of those results from the YUKOS affair over the past couple of months.

Let me make a couple of final points about portfolio investors, on the one hand, in the financial markets, and FDI, direct investors, because they are different in their attitudes, and their approaches, and their monitoring of the news cycles on a daily basis, and their strategic planning versus gut and instinctual reactions to the way the market is headed.

For portfolio investors, obviously, markets go up and markets go down, and the Russian financial markets are highly volatile and sometimes have sort of capricious reactions to news cycles. So, in any 24-hour basis, markets will go up, and it's not unusual in the past couple of years to see the Russian market swing 5 percent or more on a daily basis, and you have to ride the roller coaster and have the stomach for that versus the foreign direct investors who clearly have strategic planning shops and are

playing their investment plays in Russia off against a variety of other emerging market opportunities, and that is especially the case in the energy sector.

And there we're talking about 20-year time horizons, not gut reactions to pulling your money out in 24 or 48 hours on the basis of a phone call.

For the portfolio folks, the jitters have more or less calmed down. They have spun this through rationally. They've gotten the reinforcing signals that they need from the Russian Government. The market slide has, for the most part, bottomed out now, and in fact we've had three straight days of gains in Russian shares, although equities overall are still down about 20 percent from their high in October prior to Mr. Khodorkovsky's arrest, but the free-fall has now stopped, and they're picking back up.

For the FDI people, for those direct investors--the bricks and mortar folks, as we like to call them--who have long-term horizons, there is some anecdotal evidence of some pull-back with respect to plans that were on the drawing board. The latest example is a Finnish steel company, the largest steel company in Finland, which just a couple of days ago decided to call off a multi-million-dollar investment in Russia's steel industry, and we have sensed that from a couple of our members as well.

So time will tell about that, and it's equally difficult to quantify the sort of indirect impact of new-to-market players because, up to this point, the Putin team deserves tremendous credit for putting in place a stable investment framework and conducting tax reform and a variety of other policy initiatives that have increased Russia's investment rating. You know, this only happened two weeks after Moody's had upgraded Russia to investment grade. The interest was there, folks were at the doorstep,

and one will never know sort of how many people now are back-peddling from that entryway.

So, with that, I think I'll wind up, and we look forward to your questions.

MR. STEINBERG: Sorry to join you all late, and you've heard really from the insiders about how this looks from a Russian point of view. I want to take a look just a little bit about what it means for U.S.-Russian relations.

Blake was appropriately modest in saying he didn't have a crystal ball. We, at Brookings, always pretend that we do.

[Laughter.]

MR. STEINBERG: And so with a certain amount of immodesty look into the future. That doesn't mean we're always right in what's in that crystal ball, but I think we've already seen clearly the way in which the Bush administration is likely to see this and what its strategy is going forward.

It's really a product of two strands of thinking that have dominated the administration's policy towards Russia, partially from the beginning, partially from early going.

The first strand really was articulated by National Security Adviser Condoleezza Rice even before President Bush was elected in her foreign affairs article and speeches during the course of the campaign, which basically advocated a view that the United States should not meddle in the internal affairs of Russia. And underneath that were two assumptions, which is:

One, we couldn't affect what was going internally very much, in any event, but, at the end of the day, it didn't matter that much; that is to say, what we cared

about was Russia's external behavior, that we, as kind of bystanders, we obviously would like to see Russia become a more open, democratic, tolerant society, but that that didn't guarantee a--a more democratic Russia didn't necessarily mean a more friendly Russia, and a less democratic Russia didn't necessarily mean a less friendly Russia.

And so the sort of going-in proposition was we're going to look at this, in a very classic, realist fashion, and if Russia behaves internationally and does things, cooperates with us, that's our main concern, and a deep criticism of the Clinton administration for being overly preoccupied with trying to influence internal events.

That quickly, that philosophy was quickly joined by a decision, following the summit in Slovenia, for President Bush to basically see a personal stake in Putin himself and the relationship with Putin. That was a bit ironic, given the campaign's criticism of Clinton's excessive personalization of Russia policy.

But I think that Bush saw the opportunity, through the personal relationship with Putin, to reinforce what was the underlying theme of the campaign, which is what we want is a country that can work with us on the big international problems and that President Bush felt that he got a clear indication from Putin that Putin was willing to be that kind of partner.

That was cemented by the reaction by Putin to 9/11, the first person to call the president, a very strong sense that Russia could become a partner in the antiterrorism campaign, which was obviously the predominant priority for the United States following 9/11.

And so, given that structure, it's not surprising that we have not heard a great deal of angst or concern coming from the Bush administration over these events.

In some ways, the fact that it was, Khodorkovsky makes this somewhat easier, after all, this is not Tiananmen Square, this is not ordinary democratic people in the street having their rights suppressed, but this is a character who isn't designed to excite a lot of popular sympathy either in Russia or the United States.

The image of the oligarch, even the reformed oligarch, is simply not a point of attachment for rallying cries in favor of democracy. And having survived the more troubling actions by Russia and by Putin in Chechnya and then shutting down important segments of the press, I think, to some extent, the American political system has become enured to the fact that we're simply going to look the other way in terms of internal developments in Russia.

And it's very clear that so long as Putin continues to be an important partner, not only on antiterrorism, but we've seen a much more cooperative attitude by Russia towards Iraq in supporting the administration on post-war reconstruction in Iraq that it would take something far more dramatic than simply throwing an oligarch in jail for this to cause any significant rethinking of U.S. policy.

I think it's fair to say that there are a handful of people in the administration who have been somewhat more concerned about the long-term impact on U.S. interests of this triumph of the old security forces. We certainly heard from our ambassador in Moscow some deeper concerns about the fact that, in the long run, this is not only bad for Russian democracy, but bad for the United States.

But I think so long as this seems to go down tolerably within Russia itself, it's very hard to see that there could be enough fall-back here to change the course

of what is clearly an extraordinarily close set of U.S.-Russian relations and a clear strategic investment by President Bush and the administration in that relationship.

MR. NESSEN: Just before we go to questions from the audience, let me just throw out a couple of questions for discussion by everybody, and to bring in today's headlines, what do you think are the lessons for Putin and for Russia of the overthrow of Shevardnadze in Georgia?

MS. HILL: Well, I'll take a quick stab at this first of all.

In terms of what just happened in Georgia, there were some predictions from the outside that, given Russia's own history of meddling in Georgia and of involvement, certainly in the early 1990s in the Civil War in Georgia that then resulted in the secession of the two republics of South Ossetia and Abkhazia, essentially fracturing Georgia, that the Russians might somehow try to play a more nefarious role in what was unfolding, that they might try to seek their own candidate. There was also speculation about this in various quarters in the press, especially, of course, in the regional press, that somehow Russia's hand was behind this.

But I think that the Russians, like the United States, recognized that this was something quite different, that this was not just an issue of a regional president in trouble, but this was really a revolutionary moment in Georgia and that Shevardnadze had lost so much popularity that in terms of trying to intervene in some way, you would own the problem. And I don't think Russia, just like the United States or anyone else, really wanted to own the problem in Georgia and be propping up someone who was patently not the people's choice.

We saw a really dramatic series of developments on the streets of Georgia. It really is very much akin to those kind of things that you saw in Eastern Europe. The Georgians have learned quite directly from that experience. As I mentioned in my presentation, what was really a spectacular development in the case of Georgia was the fact that the nongovernmental organizations, the opposition parties, all worked together. They were highly organized, and they were actually quite well financed. This was a real dramatic change. And, Russia has played a relatively positive role in this, in conjunction with the United States. Colin Powell and the Russian foreign minister, Igor Ivanov, were in quite close contact. And the choice of Igor Ivanov to go into Georgia to try to mediate by the Russians was a very sensible one. Ivanov, in fact, has his own personal linkages to Georgia. His mother grew up in Georgia. He actually speaks some Georgian. So the Georgians saw him in a mediating role, not, Moscow coming in to interfere in any way.

So, for a change, the U.S. and Russia were almost on the same page in Georgia. This is a stark contrast to exactly a year ago when there was great alarm here in the United States, for good reasons too, that the Russians were planning on sending troops into Georgia, into the Pankisi Gorge region, to address the fact that Georgia was patently incapable of securing its own borders when there were incursions of Chechen rebel forces into this Pankisi Gorge region.

The Russian Government very directly signaled to the U.S.—Putin told George Bush directly that he was planning on sending in forces, which led to a rapid reaction here, in terms of sending in U.S. military trainers to work with the Georgian military in bolstering their abilities to deal with these security challenges.

So, in basically the space of a year, we've had a really rather dramatic turnabout because of people reading the mood of the people in Georgia accurately. I think, in many respects, we've had quite a dramatic change from the usual state of affairs in the region. And, you know, this has kind of muted, to some degree, what has been perceived by many as this U.S.-Russian rivalry in this region.

MR. NESSEN: Any other comments on this?

[No response.]

MR. NESSEN: Jim, Fiona has written a lot, and I guess others have, on the fact that Russia's goal is to become the greatest oil producer in the world, make the United States its best customer-- the United States is really in favor of that--and that this will lead to more political ties. Has anything happened with the arrest that would change that long term?

MR. STEINBERG: It certainly doesn't affect the political calculation, and I think that it also has to be understood that this is, I mean, the energy policy of Russia is a geopolitical policy. It's not only oil to the United States, it's gas to Europe. I mean, I think, in some ways, the far more profound set of political connections is the dramatic and growing dependence of Europe on Russian gas. And because, in many ways, that immediate political challenge is the most important for Russia, it's not only the most important outlet for gas, but it is the market that's going to matter most to Russia for the long term, that Russia is clearly using an energy strategy as part of that.

What's interesting, and I'd actually be interested in my colleagues' view on this, is, in some ways, one would have thought that YUKOS's strategy was consistent with that; that is, the kinds of links that Khodorkovsky was building on a business level

with both Europe and the United States would seem to have cemented that set of relationships that would have in Russia's interests. And so it's interesting that notwithstanding that these other elements of challenge that Fiona, and Blake, and Cliff have identified overcame what would otherwise seem like a straight strategy.

I think there is, certainly from the U.S. perspective, a valuable thing to diversify the sources of energy. And so in that sense, increased production and increased availability because of transportation networks of Russian energy resources is a plus, but we tend to rarify these relationships perhaps a little more than necessary and forget about the large fungibility of global energy networks.

And so it matters most when you are tied to infrastructure, and so when you can't really substitute, but especially on oil and oil for the United States, the only geopolitical significance of Russia coming on is the fact that there's going to be more global supply and more diversity, but not that somehow Russia would become the new Saudi Arabia, and therefore our relationship would be held hostage to the Russian production.

MR. NESSEN: Any other thoughts on that?

MR. GADDY: I think Jim is absolutely right on the last point, that it's a lot of wishful thinking by the Russians and a lot of maybe ignorance on the part of most Americans, myself included. You don't really have a clear idea, until you look at the figures, of where our dependencies are. Russia right now might end this year under the current projections being about as important for our oil supply as Angola, and you don't hear a lot of people talking about Angola becoming really overly important for us or not.

It's important, and it's good, and it's there, but the United States already has a fairly wide variety of suppliers, and the most important foreign suppliers of course are Canada and Mexico, and you tend to build those relationships because of proximity and economic factors, and it happens to be that the United States, these are also very good, convenient political, a political environment that we have--we've always had. And to talk about Russia becoming something on that order of importance for us, it's another order of magnitude. So far it's just sort of there on--

MR. GADDY: And to make a linear extrapolation and to say, well, it's going in this direction, and it's inevitably going to end up there, is certainly premature, it seems to me, from both the political and the economic and the engineering point of view.

MS. HILL: I think the main point here, and I'm sure Blake will comment on this too, is that Russia is much more important not so much for the U.S. state, unless we decide to specifically buy Russian oil for the strategic petroleum reserve that the United States Government has and, again, that would also be extremely costly, given the transportation problems at this point. We'd have to make a special effort and make a political decision in that regard.

But Russia is extremely important for international oil companies. I mean, it's the new frontiers, in many respects, of reserves, and it's not just the existing oil reserves that Russia has in Western Siberia, where YUKOS and others are operating, but there's great potential in the Russia Far East, Sakhalin—the Island of Sakhalin, in the Northeast Pacific—is going to be one of the oil boom areas in the next decade or so. Obviously, that's incredibly well located from the point of view of supplying with

Russian oil and gas to China, the Korean Peninsula and to Japan. So that's going to be an area to watch.

But there's also considerable, as yet undeveloped oil fields, in Eastern Siberia, in very harsh environments, and also in what the Russians call the Northern Seas, which is, of course, the coastal area inside the Arctic Circle.

Now, the big question there is how much is it going to cost to get this oil out? And though we think that there is enormous potential in these areas, it's not going to be easy to bring that to market, and a lot of analysts calculate that the Russians will need to have some kind of agreements with international oil companies in terms of working in those environments. This is over the next several decades, but you can't underestimate the importance of Russian oil overall for commercial interests as well as potentially the role it can play in the larger global marketplace.

MR. MARSHALL: I would just, Ron, come back to your question and highlight the irony that Jim has pinpointed here, in the calculus of whether Khodorkovsky and YUKOS have been working in fulfillment of a strategic national objective or to what extent are some of these maneuverings an irritant to Russian policymakers?

And we have, on the one hand, the dichotomy between YUKOS being a leader, in terms of integrating Russian companies and Russia with the West and with Europe and [inaudible], and on the other hand, the stated aspiration of Mr. Khodorkovsky to make YUKOS, by 2005, Russia's leading gas producer; thus, calling into question the monopolistic role of Gazprom, something that is in the state orbit for control and manipulation, and that may rankle some in the Kremlin.

MR. NESSEN: Let me ask one other oil question or petroleum question. The pipeline across Georgia from the Caspian area to the ports in Turkey, is that likely to be affected by the political upheaval there?

MS. HILL: Well, there's obviously been some great concern about that. The pipeline is actually underway in terms of its construction. BP, the lead in the consortium of oil companies that's going to be building this pipeline, has already begun to purchase land in Georgia and to clear the land for the laying of the pipeline. There have already been sections laid in Azerbaijan. So, of course, people are watching with great trepidation what might happen in Georgia. There was great concern that if Georgia erupted into civil war, and I guess they're not out of the woods yet, that this would put construction on hold, and this is a major investment on the part of international oil companies.

This is going to be a \$20-billion project overall in terms of the upstream and downstream elements of this pipeline. It's going to be the biggest construction project in the Caucasus; in fact, one of the biggest construction projects in terms of oil development overall currently in the world. It's not just going to be an oil pipeline. There's going to be a parallel gas pipeline running into Turkey, also from new fields developed in Azerbaijan. So there's a lot riding on this construction.

However, if we get through the next round of elections in Georgia and the situation stabilizes, if there's a Parliament that people can feel is legitimate, if we have another round of elections without the falsifications that we saw before, if there are new presidential elections and the whole political situation stabilizes, then I don't think there's any reason why the pipeline will not move forward. There is so much commitment now

on the part of the governments, including the U.S. Government and companies--they've already put money on the table-- so that I think that they will want to proceed at this juncture, provided the political situation is what one would hope it would be in Georgia in the next several months.

MR. NESSEN: Let me just ask one last question, and we'll go to the audience.

Jim, on this issue of the political situation, do you see what happened in Georgia happening in any of the other republics, former Soviet republics?

MR. STEINBERG: It's always difficult to predict. The situation in Azerbaijan, which I would happily defer to Fiona to talk about, is one that there's a certain amount of uncertainty. I mean, you have a situation of a dynastic succession going on there and not clear whether, given the tight political controls there, that that's something that can last over time. It certainly is structurally in place to be problematic over time, but whether that happens in the short term or not, harder to say.

In Armenia, things seem somewhat calmer than they were a few years ago, but there still are some deep, deep divisions within Armenian political society. So the caucuses remain a pretty unstable place, and a matter of considerable concern to the United States, both for energy reasons and also because it has become part of this sort of crescent of instability that affects movements of terrorist groups and transport of contraband material. And so it is becoming increasingly a strategic focus I think both for the United States and for Europe.

MR. NESSEN: Okay. We'll take questions, and we have folks that will bring microphones around, and wait until the mike reaches you, and then if you would stand up and identify yourself. Let's start over here with this gentleman right here.

QUESTION: Dmitry Gorenburg, Woodrow Wilson Center.

I have a question that would bring you back to the book. And when you talk about shrinking the Russian economy and shrinking the population of Siberia, it sort of brings up security questions, and I wonder if you address those in the book, as far as Russians always being concerned about Chinese migration or just underpopulation of a strategically sensitive region. And I wonder whether you've thought about how that could be dealt with and whether there are any answers.

MR. GADDY: We do deal with it in the book, and so I'll encourage people to take a look at the more detailed explanation there. But there are just a couple of issues to be addressed.

We think that the Russian instinctual response to a perceived Chinese threat of taking over the Eastern parts of the country—the response being to move more warm bodies out there—is wrong. The United States didn't do that with Alaska. We didn't think that was the way to protect Alaska. There are slightly more advanced, high-technology ways of doing it.

The second point is an economic argument, and you often hear this from Russians--I've heard from others, but especially from Russians--an analogy from physics that somehow you can look at the map, and you can look at population densities on the Chinese side, very dense--compared to the Russian side, it's almost empty--and that it's

like in physics: vessels with liquids in them. One is empty and one is full, and if you connect them, somehow the full one will always pour over into the empty one.

That doesn't make sense economically. If that were true, there wouldn't be a New York City. Why wouldn't everybody just flow out into the hinterlands somehow? It's just the opposite in economics. People, and economic activity, people are attracted to places where there's dense populations, where there's a lot of economic opportunities, and in fact that's pretty much what's happening with the Chinese that are in the disputed numbers, but the Chinese that are in Russia and the Far East are going to the places where there are enough Russians to trade with and enough Russians who want to buy the stuff they bring in from other parts of Asia.

And so we get kind of a weird logic from the Russian side, by Russian nationalists who say there are too many Chinese out there. "We need to have some more Russians." Well, as we argue in the book, you can't bring the Russians there for free, so you've got to subsidize them. Where do subsidies come from in Russia? They always come from gas. Gazprom is the source of all subsidies in Russia, ultimately. So you move more Russians to the Far East. Were this to happen, you would subsidize with more gas, move more Russians. The reality is that that would attract more Chinese because they want to trade with these Russians and sell stuff to them. So more Chinese come.

But the Russian nationalists says, "Oh, my god, there's more Chinese. We obviously don't have enough Russians. Let's get some more Russians, get some more gas to subsidize some more Russians."

Well, when you think about that, you're really left with which is going to run out first? Russian gas, a nonrenewable resource, or Chinese people?

[Laughter.]

MR. NESSEN: Any other answers?

Question right here?

QUESTION: My name is Solomon Karaskwan [ph], freelancer.

I'd like to ask you why Khodorkovsky was put in jail. The reason they put Khodorkovsky's company was passing out money for [?] Party, Communist Party and Socialist Party, [?] Party, and the Democratic Party. All of them is 18 parties in Russia. This is the reason they put [?] this organized crime practically is. You cannot put your money without knowing. I think that's the reason they put in jail.

At the same time, the other side, the oil companies, most of them foreign oil companies, involve investment money in Iraq.

MR. NESSEN: Do you have a question?

QUESTION: Yes, that's the question--the reason they put in jail Khodorkovsky is passing out the money to Communist Party, Socialist Party, radical and [?] Party.

MR. STEINBERG: I'll offer a comment in response and agree with you that among most observers that we talk to, certainly the political motivation is part of factoring the rationale behind the actions. That's something that folks are paying a lot of attention to. He has, Mr. Khodorkovsky, had provided funding in an election year to Yabloko, and SPS, and the Communist Party. He had also, as Fiona alluded to in her remarks, done what they might have perceived to be tampering, with respect to lobbying

in the Duma, against the PSA legislation for favorable tax loop holes and, in some way, abrogating the understanding, if not outright explicit agreement, that President Putin had cut with the oligarchs a couple of years ago: We are not going to revisit these deals. You stay out of politics.

Some people may be of the opinion that he crossed the line. And clearly, moving onto your second point, clearly there's some major Russian enterprises that play the game and some may perceive that YUKOS did not.

Blake, you talked about investment in Russia, different types of investment. Did the freeze on YUKOS shares have any effect on investment in Russia, the atmosphere for investment in Russia?

MR. MARSHALL: It certainly had a temporary and immediate adverse impact on Russian equities and the securities market there, both with respect to YUKOS shares, which tumbled dramatically, and the overall index, the RTS. The Russian market is still down from that point, from the sequestration, which was just a few days after the arrest of Mr. Khodorkovsky, the last couple of days of October, and it has not yet fully recovered from that, having just reached an all-time high. It's still down about 20 percent or so.

MR. NESSEN: Other questions?

Over here?

QUESTION: Virginia Young from [?] International Technology and Trade Associates.

I have a question regarding the oil pipeline projects, particularly the consideration about the pipeline from Murmansk in the Far Eastern pipelines. Do you

have any comments on whether the YUKOS affair will have an impact on those two projects and what the Russian Government's decisionmaking may be in the coming months in those?

Thank you.

MR. MARSHALL: Would that I knew--

[Laughter.]

MR. MARSHALL: --the Russian Government decisionmaking on these projects. There are two projects, the Murmansk project in the Arctic North for trans-Atlantic shipments, first of oil and then possibly of LNG later on, to the United States is of huge importance to us, as Fiona has discussed in her remarks. It's of strategic significance to American foreign policy.

With respect to the other pipeline that I think you've alluded to, the Angarsk-Daqing pipeline from Siberia into the Chinese market. It was one that was principally advocated by YUKOS, as opposed to the Transneft favorite, which was Western Siberia out to Nakhodka to service specific markets. There's a dispute about whether the off-shore take in Sakhalin from the deposits that are already under development there is enough to supply those Asian markets or whether another land-based line should run at twice the length, twice the cost sort of calculation to Nakhodka.

It seemed, months ago, that it was well on its way--in fact, it had received preliminary approvals; that is, the YUKOS-supported line from Angarsk to Daqing. That is no longer the case. We have seen an incremental pull-back from the support for that pipeline to where now it's safe to say, in a very colloquial way, that it's off the table

and no longer being pursued actively. Again, cause-and-effect linkage, we don't have any basis for that, but it's not moving forward as quickly as the Murmansk project.

MR. : I would just say, having just come back from Tokyo, folks in Japan see this as a part of the element of the political decision, that this was in the calculation was a feeling that Khodorkovsky was too close to the Chinese and that they are certainly seeing this as a political signal, as well as an economic signal on the decision on that pipeline.

MS. HILL: I think the pipelines certainly did feed into whatever calculations were made in Moscow by Khodorkovsky, precisely because, as Blake has pointed out, the pipelines that were being suggested, both to Murmansk and Daqing were, in essence, what Khodorkovsky was trying to negotiate were private pipelines. And Blake mentioned the fact that YUKOS was trying to move into gas, to basically become a major gas producer by 2005. Because it was trying to move into pipelines, it tried to break the monopoly of Transneft that Blake mentioned, the Russian state pipeline monopoly.

So, obviously, YUKOS and Khodorkovsky crossed swords with many of the major players in the Russian economy and were already in a debate about the Murmansk pipeline. Khodorkovsky was trying to get U.S. financial support and other international investors interested in this pipeline to force the issue, to try to get this pipeline built, which would not necessarily have been at the expense of the Russian state, because the state also wanted to have this pipeline built for all of the reasons outlined about supplying more oil to the West and to the United States, but really at the expense of the vested interests that are close to the state, of the people who run

Transneft, the people who run Gazprom (the gas monopoly), and the people who run the more state-controlled oil companies.

There was really a constellation of forces gunning for Khodorkovsky by the end for a variety of reasons related to many of the things that he was doing, in terms of promoting civil society and many of the ventures that he was involved in, in the industry. In many respects, he was kind of a revolutionary oligarch. He was really trying to tip the apple cart on all sides and trying to push through vested interests and to really pursue the interests, rather narrowly defined, of his company.

I mean, many of us could argue about—would it have been good for Russia over the long term? But for those people who were sitting in Moscow, from the perspective of the state, it was obviously not good for them at all. So there were an awful lot of people I think opposed to what he was trying to do.

MR. GADDY: I wonder if I could just make a brief comment on--I think that question really brings up a broader issue of what will happen in future economic policy in general in Russia after this affair.

One of the things that has happened that may or may not have been intentional is an empowerment of a segment of Russian policymaking associated with the security services people often use this term, "siloviki." These people from the so-called power structures will have more influence over policy. And I believe that that, of course, is true, but the one caveat I would make is that this is not an undifferentiated mass. There are people there with very, very different views. Putin himself is the prime, allegedly the prime exponent of this FSB faction, and I think he has had, at least in the past, very different views of how economic policy should be shaped in Russia than many

of the people that come from the same background, from the same institutional background.

Jim pointed out the irony that it seemed like, didn't it seem like Khodorkovsky was doing the right, exactly what one might want to happen with the Russian oil industry and business in general, opening up these channels to the West and doing things that had been unprecedented in the past.

I think that Mr. Putin had hoped that that's what he could achieve by bringing on board people like Khodorkovsky and the other oligarchs, the other people controlling certain of the strategic economic assets of Russia, strategic indices of Russia, find a way to square the circle I defined earlier, find a way to get a market economy that would be more efficient, but still serve the interests of this powerful state that Fiona described.

All the time, there is no question in my mind that from the beginning when Mr. Putin said, we can get these guys to play ball with us. They won't do it voluntarily. We're going to have to show them what happens if they don't play ball, and so you have a Berezovsky and Gusinsky case, but we present it on the table and say, look, you guys can keep these industries. You can line your pockets, but you have to play as patriotic oligarchs, as they were called.

Putin was criticized from the beginning about this, people saying that you're incredibly naive. This is absurd. This is not going to happen, and I am sure that they are gloating now. They are the ones that, if you look back now at certain proposals about especially the oil and energy sectors, they have been saying that the problem with these oligarchs is what Fiona described. Their shortsightedness, their short time

horizons. It's almost asset stripping what they are doing. They are trying to maximize cash flow and profits now. They're failing to invest in the future for this very sector that we hope will become our new claim to fame, what makes us a superpower in the world.

And so now the fight has been about this, but it's been a latent one. The question now is has this very nationalistic, basically anti-market, relatively more anti-market than Putin faction gained a strong enough hand that they will start to really assert themselves? I think you see this everywhere. I think you see it in all aspects. You see it at the highest levels of economic policy. You see it, Blake and his colleagues at the Business Council have seen it operate on the lower levels of FSB or security personnel getting involved in intervening in businesses in a way that they might not have dared to do before. It's very blatant.

A week ago, out in the Urals, in Chelyabinsk, oblast, the former regional FSB head, founded a new organization that has the acronym UFSB, which is exactly the acronym for regional branches of the FSB. This didn't stand for the regional branch of the Federal Security Service, this stands for the [speaking Russian], the Urals Federation for Support of Business. It's a new small business promotion association. The guy blatantly chooses the name that has the same acronym as the UFSB. It's like the mafia, the example in the United States is the notorious example, of Middle Americans for Industry and Agriculture.

[Laughter.]

MR. GADDY: I mean, but the brazenness about it is what I think is more a disturbing sign of the times.

MR. NESSEN: This is probably a good place to stop.

Any other final words?

MS. HILL: There's a final question.

MR. NESSEN: Oh, I'm sorry. Excuse me.

Garrett, sorry.

QUESTION: Maybe you were right. Maybe it should have been the final question.

I'm just curious the conversation about domestic Russian politics. Earlier this month we heard Andy Kohut talk about the political landscape in America in 2004, which that research characterizes as evenly divided and increasingly polarized.

And my question is whether that phenomenon, that descriptor fits in any way with domestic Russian politics and, if not, whether there is a quick way for you to sort of give us some descriptor that does.

MS. HILL: Well, I don't think one could quite describe Russian politics in the same way. I mean, that many of the things that Putin has done have been quite popular on the public level in Russia. Russian public opinion polls show that Putin's personal popularity—because, of course, he's not wedded to any particular political party, as this legacy of the Yeltsin era—has stood fairly constant, and it's been around 70 percent for some time now.

Even at the same time that we've seen the popularity of many other world figures wax and wane, Putin has had really enviable ratings in the Russian polls, and that's partly because he's been able to provide, he's been able to deliver.

I don't think people in Russia or the public at-large, just like the Bush administration that Jim has described, have been over-alarmed by what's happened. In

fact, the arrest of Khodorkovsky has been quite popular. This is kind of justice prevailing over a robber baron who has stolen the state assets and enriched himself while, you know, while a lot of the Russian population has lost a great deal as a result of the transition in Russia. If the state is strong, people are not concerned, as long as that provides stability.

So it's kind of the analog to Russia cooperating with the United States on the big issues—provided the state pays the bills, in terms of providing subsidies in these really stressed areas, in terms of climate and distance and also providing state employees with their wages and paying people's pensions. Those were all of the things that people were most concerned about throughout the 1990s, when you looked at political polls. They weren't concerned about how Russia was behaving on the international stage. They were most concerned about their own economic situation and well-being.

And while the Russian Government can continue to guarantee this, there is not a great deal of division in the country. There has been a great deal of concerns in liberal circles and among the intelligentsia, and those in nongovernmental organizations, especially among Moscow elites, about what has been happening.

But really, at the public level, I think there is a great deal more equanimity, and we'll probably see that in turnout for the Russian polls, for the Russian elections in a week or so. There's a lot of predictions that they'll get incredibly low voter turnout because people just really don't see there being any of the great choices or decisions that there were in the early 1990s. There's not even the resurgence of the Communists. As I mentioned, the Communists are just offering nostalgia for the Soviet past, which Putin himself is offering, plus a new kind of market-oriented tinge.

There's not really a great deal for people to decide, as far as they're concerned. There's not really the great big political debates or the great revolutionary moments like across the border in Georgia.

So I think people, again, are just kind of trucking along, unless there is a huge downturn in the economy, which, while there's instability in the Middle East and world oil prices remain high, I don't think there will be for some time.

MR. NESSEN: So no red states and blue states in Russia.

Jim, any final words? Blake?

Thank you all very much to the panel.

[Applause.]

MR. NESSEN: Thank you for coming.

The book you've heard talked about here today is called, "The Siberian Curse: How Communist Planners Left Russia Out in the Cold." It's for sale across the lobby here in the bookstore, 20-percent discount, and lots more--

[End of Recorded Segment.]