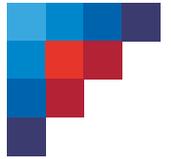




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The Tsar and His Business Serfs

Russian Oligarchs and SMEs Did Not
Surprise Putin at the Elections¹

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Executive summary

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Despite deteriorating economic conditions, the Russian business community has remained loyal to the Kremlin. It has not protested or even questioned Vladimir Putin's main domestic and foreign policies. A state monopolistic model of the economy had already been in deep crisis before Western sanctions against Russia over Ukraine started and oil prices collapsed. However, both the government and business are reluctant to publicly admit this. Instead, the Kremlin has promised to help small and medium-sized businesses with predictable fiscal policy and relaxed regulation, but it has consistently failed to do so. The entrepreneurs, in turn, have mostly reacted with more austerity and by moving into a shadow economy.

As for the oligarchs, the elites have not become divided over the relatively mild Western sanctions, as Putin has managed to keep the wealthiest power brokers at bay through a variety of carrot-and-stick policies. Large commercial entities continue to rely on state contracts and other government support, while the Kremlin's business insiders have been finding innovative ways to circumvent Western sanctions. Given the current level of relatively superficial sanctions, the US and the EU will probably have to play a long-term game before the Kremlin changes its aggressive domestic and foreign policies.

Keywords Oligarchs – Russian economy – Business elite – Sanctions – Oil price – Economic inefficiency – Monopolisation – Loyalty to Kremlin

¹ This paper's initial conclusions were presented by the author at a briefing for US Congress staff organised by the Foreign Policy Initiative and FRF on 6 June 2016.



Introduction

There are many signs that the Russian economy is facing dire times this autumn and that the difficulties will continue into next year. This is being brought about mainly by the cumulative force of economic system inefficiency, falling commodity prices and Western sanctions. With macroeconomic uncertainty and the looming depletion of state financial reserves, the question arises as to what their political impact on Russian society might be. That is, how much longer will the current domestic and foreign policies of the Kremlin be tolerated without any significant protest?

However, even under the growing economic instability and unpredictable investment climate, there has not yet been a visible political impact on the loyalty of the business elites to the Kremlin. Large oligarchic clans are mostly combining public displays of loyalty to the regime with continued efforts to remove some or all of their assets out of Russia. When they cannot move capital out of the country, they try to scale down or disassociate themselves from the most unprofitable domestic projects (such as the construction of a bridge to Crimea, discussed below).

At the same time, the latest developments suggest a gravely deteriorating economic environment for small and medium-sized enterprises (SMEs), which are being taxed down or simply pushed out of business by administrative measures. The conditions are particularly harsh for them since, with virtually no access to affordable loans, they are facing aggressive competition from oligopolies.

This paper examines the impact of the economic downturn on the business environment, based on economic indicators, known commercial developments and public statements by key business figures.



The current economic crisis and its impact on the Russian business community

Over the last year, top government officials have periodically promised that the Russian economy had ‘hit bottom’ and was finally on the path to recovery. However, this has proved to be an ever-vanishing line on the horizon. In fact, some of the leading independent experts have recently found that the ‘economy had fallen below the bottom’, almost all sectors are in the red and reserve funds could be depleted in 2017.²

Despite deeply deteriorating macroeconomic indicators (the inflation rate,³

² See the latest conclusions by experts from the Higher School of Economics, Евгений Калюков, Эксперты ВШЭ заявили о падении экономики России ниже дна [HSE Experts Stated that the Russian Economy has Fallen Below the Bottom], *RBC*, 1 April 2016, accessed at <http://www.rbc.ru/economics/01/08/2016/579f06e69a79471547947e3d> on 7 September 2016; and an analysis of Russian finance by ex-Central Bank official Sergey Aleksashenko, ‘Sergey Aleksashenko: The Budget Situation is Lousy’, Institute of Modern Russia, 3 August 2016, accessed at <http://imrussia.org/en/analysis/economy/2600-sergey-aleksashenko-the-budget-situation-is-lousy> on 30 August 2016.

³ The annual inflation rate reached almost 13% in 2015. *gks.ru*, Об индексе потребительских цен в декабре 2015 года [On the Consumer Price Index (CPI) in December], (n.d.), http://www.gks.ru/bgd/free/b04_03/lssWWW.exe/Stg/d06/1.htm, which is the worst indicator since the financial crisis in 2008. ‘Historic Inflation Russia. CPI Inflation’, *Inflation.eu* (n.d.), accessed at <http://www.inflation.eu/inflation-rates/russia/historic-inflation/cpi-inflation-russia.aspx> on 7 September 2016. As with other key macroeconomic indicators, authorities have reinvigorated the campaign to present inflation as waning in 2016. Зампред ЦБ Юдаева: инфляционные риски в России возросли [Deputy Chairman of the Central Bank Yudaeva: Inflation Risks have Increased in Russia], *BBC.com*, 14 January 2016, accessed at http://www.bbc.com/russian/business/2016/01/160114_central_bank_yudaeva_interview on 30 August 2016. At the same time, the latest reports from the Bank of Russia and the Central Bank show they have no clear view of inflation rate, as there are conflicting opinions on new patterns of consumption and price outlook. See Поддержанная, но крепкая инфляция [Used, but Strong—Inflation], *Kommersant.ru*, 9 August 2016, accessed at <http://kommersant.ru/doc/3058908> on 7 September 2016; ЦБ объяснил парадокс падения розничной торговли при росте зарплат [The Central Bank Explained the Paradox of the Fall in Retail Trade Along with an Increase in Wages], *rbc.ru*, 8 April 2016, accessed at <http://www.rbc.ru/economics/08/08/2016/57a8a87c9a7947dc37e8fccb> on 30 August 2016. However, independent sources suggest the inflation rate could go above the official target of 6% amid claims of possible manipulation with inflation numbers by Rosstat on items like food and other necessities. Предъявляем счет: насколько подорожали продукты [We Present the Bill: How High Product Prices Have Grown], *BBC.com*, 25 January 2016, accessed at http://www.bbc.com/russian/business/2016/01/160125_prices_shops_data on 30 August 2016.



budget deficit⁴ and exchange rate) and the investment climate⁵ after the start of the Kremlin's invasion of Ukraine, the Russian business elite remains compliant with the major economic and warfare spending policies of the government.

The only mildly critical voices surfacing publicly are those of the group that the media have termed 'systemic liberals': German Gref, Elvira Nabiullina and Alexey Kudrin and; top officials from the Ministry of Finance or Economic Development and Trade; and, occasionally, oligarchs closely associated with the regime, such as Oleg Deripaska.⁶ All their criticisms are aimed exclusively at the economic, not political, policy of the government and never assign direct blame to the president or presidential administration. Total and unquestionable loyalty to Putin and the Kremlin is the ultimate capital of Russian business elites, not their billions, assets or prerogatives, all of which can be lost very quickly after a perceived act or word of betrayal or defiance.

As with the pre-electoral disinformation which was sold to the Russian population,⁷ the official story the government has been telling the Russian business community over the last two years is that the economic crisis is nearing an end and that the government supports businesses. Top officials and propaganda try to reassure the private sector that, despite all setbacks, import substitution is working and the economy is likely to

⁴ The federal budget deficit was 2.6% of GDP in 2015, more than four times higher than originally planned at 0.6% in late 2014. Минфин подсчитал дефицит бюджета России в 2015 году [The Ministry of Finance Has Calculated Russia's Budget Deficit in 2015], *Slon.ru* 22, January 2016, accessed at <https://slon.ru/posts/62890> on 30 August 2016. This year, the Ministry of the Economy is hoping for 'only' a 5.1% deficit under a \$40 per barrel of oil scenario and a large-scale privatisation campaign. Разведанные запасы прочности [Explored Reserves of Durability], *Kommersant.ru*, 8 February 2016, accessed at <http://www.kommersant.ru/doc/2911191> on 30 August 2016.

⁵ See '2016 Index of Economic Freedom—Russia', *Heritage.com* (n.d.), accessed at <http://www.heritage.org/index/country/russia> on 7 September 2016. Even Russia Direct, a website known as a moderate version of the Russia Today channel in the West, admits serious problems with Russia's investment climate: P. Koshkin, 'How the Economic Crisis Hampers Russia's Investment Climate', *Russia Direct*, 21 January 2016, accessed at <http://www.russia-direct.org/qa/how-economic-crisis-hampers-russias-investment-climate>, on 30 August 2016.

⁶ Even the current outsider from the political system, Alexey Kudrin, avoids criticising any foreign or domestic political policies and says that he is politically indifferent and simply requests 'more acute public debate'. Алексей Кудрин: мы не можем говорить, что пик проблем пройден [Alexei Kudrin: We Cannot Say that the Problems Have Already Peaked], *Interfax.ru*, 28 December 2015, accessed at <http://www.interfax.ru/business/487406> on 30 August 2016. Deripaska has been particularly vocal in the last 12 months against the Central Bank with its policy of high interest, demanding financial help for the private sector from the government.

⁷ Vladimir Milov recently analysed the pre-electoral campaign of disinformation. See his 'From Disapproval to Change? Russia's Population May Surprise Putin at the Next Elections', Wilfried Martens Centre for European Studies, Brussels, accessed at <http://www.martenscentre.eu/publications/disapproval-change-russias-population-may-surprise-putin-next-elections> on 30 August 2016.



rebound. Moreover, the country has enough financial reserves to get by in the interim.⁸ The ongoing de facto rouble devaluation is downplayed, while the declining flight of capital in 2015 compared to 2014 is presented as an achievement.⁹

What the government has been reluctant to admit is that the state monopolistic model of the economy had proved ineffective and was already in deep crisis before sanctions started and oil prices collapsed. The crisis of the last two years has only highlighted the systemic problems that had existed in Russia before 2014—it did not create them. In 2013, industrial growth was at zero and GDP growth was 1.3%.¹⁰ This happened despite an increase of total budget investment injections to a staggering 1.8 trillion roubles while investments by the 10 largest state companies stood at 3 trillion roubles.¹¹

A decrease in commodity prices, especially in oil and gas, led to plummeting budget revenue, but the trade balance and expenses have remained largely the same (paid by reserves and through the budget deficit). Saudi Arabia achieved 3.64% growth in 2014 and 3.49% in 2015 despite being a petro-state like Russia.¹² The fundamental problem with Russia is not overdependence on oil exports per se but a lack of genuine restructuring of the economy and an absence of rational austerity measures that could lead to long-term efficiency.

Instead of admitting these problems, President Putin has personally reassured oligarchs and smaller entrepreneurs that the state will support

⁸ With the notable exception of the deputy minister of finance, Tatyana Nesterenko, who recently warned that without an enhanced austerity strategy, reserves might be depleted as early as end of this year. Минфин: Без реформ Россия проест резервы к концу 2017 года [Ministry of Finance: Without Reforms Russia will Spend its Reserves by the End of 2017], *Vedomosti.ru*, 30 July 2015 accessed at <https://www.vedomosti.ru/economics/news/2016/07/30/651118-minfin-bez-reform> on 30 August 2016.

⁹ The lower capital flight in 2015 (\$57 billion) is roughly three times smaller than in 2014 (\$153 billion) mainly because a) most capital that wanted to leave the country did so quickly after war in Ukraine started, b) the Russian economy is contracting and c) there is a lack of access to an international credit system for Russian business. Почему новость об уменьшении оттока капиталов из России не вызвала радости [Why the News about Decrease in the Outflow of Capital from Russia Has Not Caused Any Joy], *Profi-forex.org*, 20 January 2016, accessed at <http://www.profi-forex.org/novosti-rossii/entry1008280748.html> on 30 August 2016.

¹⁰ Рост ВВП России в 2013 г. составил 1,3% [The Growth of Russia's GDP in 2013 Amounted to 1.3%], *Interfax*, 31 January 2014, accessed at <http://www.interfax.ru/business/355147> on 30 August 2016.

¹¹ Госсектор разочарований [The Public Sector of Disappointment], *Gazeta.ru*, 24 September 2016, accessed at <https://www.gazeta.ru/comments/column/milov/5666661.shtml> on 7 September 2016.

¹² Worldbank GDP Growth (Annual %) (n.d.), accessed at <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=SA> on 7 September 2016.



business (through personal meetings, organisations such as the Russian Union of Entrepreneurs and Industrialists, and business associations such as Opora). Over the last two years Putin has often come out with empty propagandistic messages that, in response to sanctions, the government would definitely provide more regulatory freedom and support to the business community.¹³ During his latest meeting with Sberbank CEO Gref, he stated in front of television cameras that ‘small businesses are not meddled with’.¹⁴ The president and the government have also repeatedly referred to import substitution and reorientation to Asia Pacific, BRICS¹⁵ and lately Turkey and other non-Western markets as great windows of opportunity for Russian trade.

However, the overwhelming response to these messages has been a lack of trust in the government’s words and policymaking among various business circles in Russia. This can be seen in the huge flight of capital and the depressed domestic investment across all major sectors of the economy. While experts argue about what has had a stronger and more lasting influence on Russian economy—Western sanctions or the falling oil price¹⁶—the majority of business leaders and economists agree that systemic economic problems existed prior to the annexation of Crimea. Bloated and inefficient state corporations, a disincentive to raise productivity, red tape and widespread corruption have been evident for years.

None of these systemic problems have gone away, and now the business community is facing the cumulative effect of the defects of state capitalism along with sanctions and falling commodity prices. As a result, this perfect economic storm has hit SMEs the hardest, and the oligarchs

¹³ For example, Путин заявил о расширении свободы бизнеса в ответ на санкции [Putin Announced Increased Ease of Doing Business in Response to Sanctions], *rbc.ru*, 25 December 2015, accessed at <http://www.rbc.ru/rbcfreeneews/567c60069a79473e90d6d29c> on 30 August 2016; Путин пообещал поддерживать малый и средний бизнес в условиях санкций [Putin Promised to Support Small and Medium Business under Sanctions], *MK.ru*, 20 January 2016, accessed at <http://www.mk.ru/politics/2016/01/20/putin-poobeshhal-podderzivat-malyy-i-sredniy-biznes-v-usloviyakh-sankciy.html> on 30 August 2016.

¹⁴ Путин на встрече с Грефом призвал не усложнять работу малому бизнесу [Putin at a Meeting with Gref Urged not to Complicate Operation for Small Businesses], *Tass.ru*, 4 August 2016, accessed at <http://tass.ru/ekonomika/3510138> on 30 August 2016.

¹⁵ BRICS stands for Brazil, Russia, India, China and South Africa.

¹⁶ Most researchers suggest that the oil price has a stronger short-term impact, sanctions adding to overall strangling effect through the credit crunch, while the two factors strongly reinforce each other and systemic problems that existed prior to 2014. Yevsey Gurvich and Ilya Prilepsky suggest that falling oil export revenue will cost Russia \$400 billion in 2014–17, and losses from financial sanctions will amount to \$170 billion under the \$50 per oil barrel scenario. Экономика России лишилась 8,4% роста [The Russian Economy has Lost 8.4% of Growth Rate], *Vedomosti*, 5 February 2016, accessed at <http://www.vedomosti.ru/economics/articles/2016/02/05/626922-ekonomika-lishilas>, on 30 August 2016.



around Putin have also been negatively impacted by the chilling effect of sanctions and gloomy economic prospects. All groups are reducing their investment activity and are trying to adapt to the new environment.

Changes in the expectations and perceptions of SMEs not directly connected to Kremlin insiders

SMEs have suffered significantly in the last year despite Putin's order in April 2015 to develop a long-term strategy to support them up to 2030. That document was supposed to be released before 2016,¹⁷ but in the end the government approved and published it on 2 June 2016.¹⁸ It claimed to offer more accessible bank credits, predictable fiscal policy, stimulated demand through state contracts and other measures.

However, actual positive results were marginal. For example, the government called for a three-year moratorium on inspection starting 1 August for small businesses with a turnover under 60 million roubles. Also, state contracts for SMEs were slated to rise from 15% to 25% of total state contracts. Reportedly, inspections did not decrease, and even a 15% share was not sustained.¹⁹

A new non-tax trade fee and transport and environmental fees were introduced in spite of prior promises of support and predictable fiscal policy. Despite falling oil prices, gasoline prices rose in roubles in 2015, further hindering business activity, as oil companies were allowed to

¹⁷ E. Gorelova and M. Podzerob, Малому бизнесу придумали стратегию развития до 2030 года. На ближайшем этапе – отмена административных и законодательных барьеров [A strategy for development until 2030 was created for small businesses. The first steps should be to remove administrative and legislative barriers], *Vedomosti*, 14 October 2015, accessed at <https://www.vedomosti.ru/management/articles/2015/10/15/612888-malomu-biznesu-privdumali-strategiyu-razvitiya-2030-goda> on 12 September 2016.

¹⁸ Russian Federation, СТРАТЕГИЯ развития малого и среднего предпринимательства в Российской Федерации на период до 2030 года [Strategy for the development of small and medium-sized entrepreneurship in the Russian Federation for the period up to 2030], no. 1083-р, 2 June 2016, accessed at <http://government.ru/media/files/jFDd9wbAbAp-xgEiHNaXHveytq7hfPO96.pdf> on 12 September 2016.

¹⁹ 2015 год обещал малому бизнесу—и что исполнил [What 2015 Has Promised to Small Businesses—and What Has Been Done], *Vedomosti* Что, 22 December 2015, accessed at <http://www.vedomosti.ru/management/articles/2015/12/23/622134-cto-2015-god-obeschal-malomu-biznesu-cto-ispolnil> on 30 August 2016.



compensate for their export losses at the expense of consumers in the domestic downstream market.²⁰ New individual entrepreneurs, registered in 2015, were supposed to receive three-year tax holidays. However, the decision to implement the tax break was left to regional authorities, who in the end hardly applied it.

In fact, in the last 12 months, the government has experimented with new forms of taxation in order to alleviate the widening budget deficit. Along with other measures, the government introduced new fees for residential maintenance, a reworked and more burdensome property tax and finally, a higher dividend tax rate. As described in a paper by Vladimir Milov, these taxes have fuelled some, if limited, social discontent and led to the first visible public protest in Russia's recent history, organised by truck drivers.²¹ Moreover, the revenue generated by these unpopular measures has been marginal.

SMEs are fearful that there is a significant risk the government will be tempted to increase one of the easily administered taxes that make a sizeable contribution to the budget, such as excise tax on gasoline.²² There is also a possibility of halving the tax cut, which would hit revenues of all oil producers in Russia, both big and small.²³ Moreover, if Putin does not allow the Ministry of Finance, faced with a burgeoning budget deficit, to raise taxation in the oil and gas industry, it may instead resort to a new 'tax manoeuvre' in the wider economy, raising the VAT and reducing the profit tax.

In addition to introducing rampant tax increases, some regional authorities have resorted to outright unlawful coercion by closing down street kiosks and urban retail spots. Moscow has led this trend, which culminated in the demolition of hundreds of kiosks in the spring and summer of 2015. However, this phenomenon has been present in the regions

²⁰ Почему бензин в России не дешевеет вслед за нефтью? [Why is Gasoline in Russia not Getting Cheaper Along with Oil?], *BBC.com*, 12 January 2016, accessed at http://www.bbc.com/russian/business/2016/01/160112_qd_russia_fuel_price on 30 August 2016.

²¹ From Disapproval to Change? Wilfried Martens Centre for European Studies (Brussels).

²² Правительство одобрит законопроект о повышении акцизов на топливо [Government Approves the Bill on Raising the Excise Tax on Fuel], *Oilcapital.ru*, 9 February 2016, accessed at <http://www.oilcapital.ru/industry/281933.html> on 30 August 2016.

²³ Нефтяников поставят на вычет [Oil Industry Workers Will Be Heavily Taxed], *Kommersant*, 8 February 2016, accessed at <http://www.kommersant.ru/doc/2911198> on 30 August 2016.



from at least 2014.²⁴ The authorities mostly asserted that kiosk owners did not have proper permits or had obtained ownership certificates without proper due process. When Moscow started the same campaign, its officials also cited the criminal connections of kiosk owners and the need to improve urban scenery by removing ‘ugly self-made and irregularly built constructions’.²⁵

Reaction to such a mix of abrasive policies has been varied. Relatively small groups of entrepreneurs, especially truck drivers and some kiosk owners, staged desperate and disparate acts of protest, but none of them made explicit political demands. On the contrary, a small group of kiosk owners reportedly put up portraits of Vladimir Putin as a protective charm against bulldozers.²⁶ By mid-summer 2016, protests against unauthorised kiosk demolitions spread to provincial towns like Serpukhov, which had rallies that sent open letters to Putin asking him to expedite the processing of complaints through Russian courts. However, there were no immediate and clear responses from Moscow authorities.²⁷

The majority of entrepreneurs have simply resorted to severe investment cuts, lay-offs and moving out of expensive rented spaces. It is characteristic for the industry that one of the regional heads of Opora said in a recent interview that, in his view, ‘Putin is misinformed’ about acute problems for SMEs. At the same time he suggested that the overwhelming majority of entrepreneurs are not planning to engage in open social

²⁴ В российских регионах все чаще стали принудительно закрывать ларьки и палатки, торгующие продуктами. Мелкие торговые объекты, в которых можно быстро перекусить, тоже попали под раздачу. Об этом заявил сегодня министр промышленности и торговли Денис Мантур [Booths and Stalls Selling Foodstuff are Increasingly Forced to Close Down in Russia’s Regions. Small Commercial Enterprises Offering Fast Food also Came under Closures. This was stated today by Minister of Industry and Trade, Denis Mantur], *Kroosp.ru*, 27 August 2014, accessed at <http://kroosp.ru/v-rossijskih-regionah-vse-chashhe-stali-prinuditelno-zakryvat-larki-i-palatki-torguyushhie-produktami-melkie-torgovye-obekty-v-kotoryh-mozhno-bystro-perekusit-tozhe-popali-pod-razdachu-ob-etom-zayav/> on 30 August 2016.

²⁵ See I. Elkov Криминальная Пирамида [Criminal Pyramid], *RG.ru*, 17 February 2016, accessed at <https://rg.ru/2016/02/17/reg-cfo/pochemu-snos-torgovyh-pavilonov-v-moskve-udaryl-po-voram-v-zakone.html> on 7 September 2016; Снос самостроя в Москве: власти обещают благоустройство [Demolition of Unauthorised Buildings in Moscow: Authorities Promise to Embellish the Vacated Space], *Ria.ru*, 9 February 2016, accessed at <https://ria.ru/moscow/20160209/1372055327.html> on 7 September 2016.

²⁶ Ночь длинных ковшей». Соцсети критикуют мэрию за снос самостроев в Москве [The ‘Night of the Long [Excavator] Buckets’. Social Networks], *Medialeaks.ru*, 9 February 2016, accessed at http://medialeaks.ru/news/0902vika_larki on 30 August 2016.

²⁷ АВН: Подмосковные предприниматели обратятся к Владимиру Путину с просьбой защитить малый бизнес [AVN: Entrepreneurs in the Moscow Region Will Turn to Vladimir Putin with a Request to Protect Small Business], *Mediatron.ru*, 28 July 2016, accessed at <http://mediatron.ru/news-2016-iyul-036808.html> on 30 August 2016.



discontent but instead have prepared to move into a shadow economy and stay away from the grip of the state as much as possible.²⁸

On 15 July, Tatyana Golikova, head of the Accounting Chamber, reported to Putin in front of television cameras that state support for SMEs had been a success, as state income from them had risen by 10% and more people had been employed in these industries.²⁹ This data contrasts with a survey published in July 2015 by the Russian Presidential Academy of National Economy and Public Administration, which found that around 30 million people, or 40% of the economically active population of 76.5 million, are part of the ‘shadow’ labour market at various points throughout the year.³⁰ Although the data from Golikova and data from the Academy are not directly correlated with each other, it seems unlikely that both are correct. A rising number of people in the shadow economy means, by definition, that they are not paying proper taxes. It is difficult to imagine a situation in which, while almost half the working population stopped paying proper taxes, SMEs somehow improved their contributions to the budget. That would mean that it is mostly big businesses that have moved into the shadow economy—but it is obviously more difficult for them to make this move than it is for SMEs.

Notably, in mid-2015, the audit and management consultancy firm KPMG conducted a survey of what SMEs consider the main challenges in Russia under US sanctions. The study found four key problems, which those surveyed ranked in order of importance as follows: highly limited access to credit lines, poor business climate, issues with human resources and oligopolisation/lack of access to markets.³¹ One of the most interesting findings of the survey is that major challenges for doing business were the same before and after 2014—only their ranking had changed.

²⁸ Опора России: «Путина дезинформируют» [Support of Russia: ‘Putin is Misinformed’], 21 January 2016, accessed at <http://severpost.ru/read/37342/> on 30 August 2016.

²⁹ Голикова: доходы бюджета от малого и среднего бизнеса увеличились в 2015 году на 10% [Golikova: Budget Revenues from Small and Medium Business Increased in 2015 by 10%], *Tass.ru*, 15 July 2016, accessed at <http://tass.ru/ekonomika/3456206> on 30 August 2016.

³⁰ Putin Peers into Shadows Where 30 Million Toil on Fringes’, *Bloomberg*, 13 July 2016, accessed at <http://www.bloomberg.com/news/articles/2016-07-13/putin-peers-into-shadows-where-30-million-toil-in-fringe-economy> on 30 August 2016. Малый бизнес назвал четыре главные проблемы [Representatives of] Small Business Named Four Major Problems], *rbc.ru*, 15 September 2015, accessed at <http://www.rbc.ru/economics/25/09/2015/560574bf9a7947d1198f6d29> on 7 September 2016.

³¹ Российские миллиардеры потеряли от санкций и нефти до 40% состояния [Russian Billionaires Have Lost up to 40% of Their Wealth Due to Sanctions and Slump in Oil Prices], *rbc.ru*, 27 May 2015, accessed at <http://www.rbc.ru/business/27/05/2015/5565f5ae9a79477d8c7374bd> on 30 August 2016.



Before the sanctions, a poor business climate was the top concern. After the West imposed credit restrictions, access to financial resources became the main headache.

Changes in the behaviour of top oligarchs and Kremlin's business insiders

According to various sources, the top 20 Russian oligarchs had lost about 40% of their wealth by mid-2015 because of sanctions and lower commodity prices.³² By the end of 2015 they had lost \$8 billion.³³ In early 2016 alone, the top 13 lost an additional \$11 billion.³⁴ However, oligarchs have shied away from criticising the regime, due to a combination of intimidation (exemplified by the expropriation of Yukos and the latest de-facto nationalisation of Bashneft) and favours from the government. Indeed, most importantly oligarchs have kept quiet and avoided criticising the regime because the overwhelming majority of their oligarchic entities received bailouts, tax breaks or some other form of financial support from the Kremlin during the financial crisis of 2008–9 and subsequently.

One possible exception to this trend that many media sources have pointed out was the forced sale of Mikhail Prokhorov's assets in Russia after his RBC media group made missteps in their reporting concerning Putin's daughters and of other sensitive information.³⁵ However, I disagree with such a view, as even with Prokhorov one still sees a fully loyal oligarch who has been allowed to sell assets at market value to close associates of the regime.

As is often the case with high-level business transactions of this kind in Russia, we do not know how much of Prokhorov's money is his own

³² Ibid.

³³ Богатейшие российские миллиардеры потеряли в 2015 году около \$8 млрд [The Richest Russian Billionaires Have Lost Around \$8 Billion of Their Wealth in 2015], *Kazan First*, 29 December 2015, accessed at <http://kazanfirst.ru/online/61050> on 30 August 2016.

³⁴ Пресса Британии: тяжелая судьба российских олигархов [Media in Britain: The Plight of Russian Oligarchs], *BBC.com*, 18 January 2016, accessed at http://www.bbc.com/russian/uk/2016/01/160118_brit_press on 30 August 2016.

³⁵ ТАСС, Голикова: доходы бюджета от малого и среднего бизнеса увеличились в 2015 году на 10% [Golikova: Revenues from Small and Medium-sized Enterprises Increased by 10% in 2015], *Tass.ru*, 15 July 2016, accessed at <http://tass.ru/ekonomika/3456206> on 30 August 2016.



and whose money he is investing in Western assets. In fact, given his continued loyalty to the Kremlin, there is no way to fully confirm that his investments are not actually a way to circumvent sanctions. One cannot rule out that he is a front man not only for his own money but also for the capital of Kremlin insiders, who are now buying his assets at surprisingly acceptable prices (at or above the current market price). Just under a year ago, Prokhorov publicly said that ownership of the Brooklyn Nets helps him to counteract US sanctions because of the human interaction between teams, professionals and common people.³⁶

Other close associates of the regime in the business elite, such as key oligarchs and officials who control multibillion-dollar cash flows, have shown remarkable flexibility in adapting to the economic crisis and accepting the sanctions. They have done so without breaking loyalty to the president and his aggressive domestic and foreign policy in five major ways:

- the transfer of assets from sanctioned individuals to relatives and/or non-sanctioned associates,
- arrangements with the government to provide preferential financial support from state coffers,
- the use of second-tier banks³⁷ and Internet banking to circumvent sanctions,
- continued business operations in the West with the help of Western enablers, and
- continued business in corrupt former Soviet countries where oligarchs feel comfortable and find criminal networks that facilitate transactions.

The transfer of Gennadiy Timchenko's stakes in Gunvor and Kolmar companies to Torbjörn Törnqvist, Iskander Makhmudov and Andrey Boka-

³⁶ Прохоров рассказал о борьбе с санкциями с помощью своего клуба в НБА [Prohorov Talked About Withstanding Sanctions with the Help of His NBA Club], *Lenta.ru*, 6 October 2015, accessed at <https://lenta.ru/news/2015/10/06/prokhorov/> on 30 August 2016.

³⁷ Second-tier or second-echelon banks are the vast majority of big or middle-sized Russian commercial banks (around 200 banks) with exception of the top 10 or 20 largest banks. Top banks are also mostly characterised by control or large stakes in the state, whereas commercial banks are not. For more information, see Распределение банков по эшелонам [Dividing Banks According to Echelons], *banki.ru* (n.d.), accessed at http://www.banki.ru/wikibank/raspredelenie_bankov_po_eshelonam/ on 7 September 2016.



rev³⁸ is the most visible example of how Putin's associates who are under sanctions are moving assets to people not under sanctions. The same move was made by the sanctioned Rotenberg brothers, who decided to transfer to their sons assets such as stakes in Mosenergo and Gazprom drilling and resort assets in Finland. Interestingly, most of the colleagues and relatives of the Rotenbergs, Timchenko and others who carried out similar transfers were later sanctioned by US authorities.

While such transfers failed in large part to protect assets from the effects of the sanctions, they do seem to have consolidated key figures around Putin (who acts as guarantor of the assets and overall stability for oligarchs). The transactions also expedited the process of creating a new generation of regime loyalists (sons and other younger relatives of Putin's elder associates). This process started before 2014, when the sons of Nikolay Patrushev, Alexander Bortnikov, Mikhail Fradkov, Sergey Ivanov and Nikolay Shamalov started to get rapid promotions to corporate positions that control significant cash flows. Reportedly, this goes all the way to Putin himself, as his alleged son-in-law, Kirill Shamalov, bought a stake in petrochemical company Sibur from Timchenko in 2014.

Sibur's case is also noteworthy because it is an excellent example of how tycoons who are regime insiders get preferential treatment when it comes to state support. Aleksey Navalny, one of the leaders of the Russian opposition, has recently brought action against Putin for his alleged conflict of interest in providing state support (\$1.75 billion) to Kirill Shamalov's projects in Sibur.³⁹ It is a very closed circle of insiders like Igor Sechin, the Rotenberg brothers, Gennadiy Timchenko and Leonid Mikhelson who get support from the national welfare fund.

One of the most visible ways in which the state supports close business associates is by transferring debts generated by unviable projects developed by private entities to the VEB (Vnesheconombank)—leaving the debts to be borne by Russian taxpayers. This state behemoth has accumulated tens of billions of dollars in external and internal debts, including those for commercially unfeasible projects from the 2014 Olympics. Recently Putin had to admit that this bank has become a garbage depot

³⁸ A. Kirilenko, Мафия на госзаказе. Как новые кремлевские олигархи связаны с преступным миром [State Procurement by Mafia. How the New Kremlin Oligarchs are Connected with the Criminal World], *The Insider*, 2 July 2015, accessed at <http://theins.ru/korrupciya/10407> on 30 August 2016.

³⁹ Подал в суд на Путина из-за зятя Путина и уверен, что выиграю [Sued Putin Because of Putin's Son-in-law and Confident That I Would Win], *Navalny.com*, 11 February 2016, accessed at <https://navalny.com/p/4724/> on 30 August 2016.



for bad debt.⁴⁰ It is estimated that the government will have to bail out the bank with up to 1.5 trillion roubles and take most of its consolidated debt at the expense of the state budget. Nevertheless, there is an ongoing dispute on the future role of the bank, as reportedly some of the business insiders still hope to get additional help from the dying bank at the expense of the state. This bank has already received substantial preferences from the state that in the next few years could amount to 2% of Russia's GDP, according to IMF estimates.⁴¹

Another subtle way in which corporate Russia finds ways to circumvent sanctions and carry on financing projects that sanctioned banks are not allowed to fund is through private banks loyal to the regime. For instance, four private second-tier banks with friendly ties to the Kremlin emerged last autumn as big winners from Russia's economic crisis, helping out dollar-starved companies at a time when large state lenders are hampered by Western sanctions. In particular, one of the main beneficiaries is FC Otkritie, controlled by Okritie Holding. The latter is co-owned by several bankers and industrial groups, all seen as loyal to the authorities but without particularly close ties with them. A 10% stake in Okritie Holding belongs to Vneshtorgbank.⁴²

However, many key oligarchs who have close ties to the Kremlin but are not on the sanctions list continue doing business with their Western counterparts or even in the West while remaining absolutely loyal to the regime and policymaking inside Russia. The most colourful examples include Alisher Usmanov and Mikhail Fridman.

Usmanov has helped the Kremlin to streamline Kommersant and other media and IT/communications companies within Russia, including the takeover of social media Vkontakte. The founder of Vkontakte, Pavel Durov, was ousted from Russia, and rules of access to private information and censorship are now executed according to the wishes of the Federal Security Service of the Russian Federation. On 30 June of this year, Us-

⁴⁰ E. Tofanyuk, «Помойка для долгов»: какие варианты спасения ВЭБа есть у правительства [‘Garbage Bin for Debt’: What Kind of Options Has Government to Save VEB], *rbc.ru*, 20 December 2015, accessed at <http://www.rbc.ru/finance/s/20/12/2015/567325aa9a7947c512c66373> on 30 August 2016.

⁴¹ МВФ посоветовал ВЭБу более качественную бизнес-модель и усиленный надзор [IMF Suggested to VEB More Efficient Business Model and Enhanced Supervision], *Interfax.ru*, 13 July 2016, accessed at <http://www.interfax.ru/business/518327> on 30 August 2016.

⁴² I. Zaslavsky, ‘How Russian Banks Survive Under Sanctions’, *Charter 97*, 14 September 2015, accessed at <https://charter97.org/en/news/2015/9/14/168909> on 30 August 2016.



manov met with Putin in the Kremlin, a visit that was reported on prime television channels. Usmanov's key message was that of support for government policy. He said that sanctions were negatively impacting the Russian economy but that his company was faring well due to the steps it had taken to improve efficiency and boost workers' morale.⁴³ At the same time, Usmanov continues to enjoy his assets in the UK (including a stake in Arsenal Football Club) and has expanded his presence in Silicon Valley companies in the US.

In mid-2014, analysts from the Henry Jackson Society, the Peterson Institute and the Centre for Strategic and International Studies named Usmanov and two other oligarchs—Mikhail Fridman and Roman Abramovich—as prime candidates for further sanctions. However, none of these three individuals was put on any sanctions lists. One can only speculate about why these Kremlin insiders were not sanctioned (as their political and financial characteristics are hardly different from those of sanctioned individuals such as Gennadiy Timchenko). US and EU authorities do not comment in detail on their selection process but instead make vague references to someone's being a 'crony of Putin' or part of Putin's or the Kremlin's inner financial circle. My guess is that these oligarchs have not been sanctioned because (1) they are still seen as potentially useful individuals for Western back-channelling with the Kremlin and (2) they had invested a lot of effort in lobbying against individual sanctions against themselves—as did, for example, Petr Aven and Mikhail Fridman.⁴⁴

Fridman, principal of Alfa Group and LetterOne Company, was at some point ready to fight the UK government in a London court on the matter of being associated with Western sanctions.⁴⁵ In the end he did not, but his Luxembourg-based Letter One vehicle has invested billions of dollars received from Igor Sechin's Rosneft in 2013⁴⁶ in European and global en-

⁴³ Владимир Путин встретился в Кремле с Алишером Усмановым [President Vladimir Putin Met with Alisher Usmanov in the Kremlin], First Channel, 30 June 2015, accessed at <http://www.1tv.ru/news/polit/286903> on 30 August 2016.

⁴⁴ M. Elder, 'Russian Oligarchs Try Cultural Diplomacy in New York. The Oligarchs Behind L1 Energy, a New Oil and Gas Concern, Open an Art Exhibit at New York's Neue Galerie', *Buzzfeed.com*, 12 May 2015, accessed at <https://www.buzzfeed.com/miriamelder/russian-oligarchs-try-cultural-diplomacy-in-new-york> on 7 September 2016.

⁴⁵ H. Amos, 'Russian Tycoon Fridman Should Make U.K. Feel Nervous', *The Moscow Times*, 10 March 2015, accessed at <http://www.themoscowtimes.com/business/article/russian-tycoon-fridman-should-make-uk-feel-nervous/517216.html> on 30 August 2016.

⁴⁶ I. Zaslavsky, Об офшорной дружбе «танкистов» и чекистов. Как «Роснефть» купила долю в ТНК-БП [About Offshore Friendship Between 'Tankers' and Security Officers. How Rosneft Bought a Share in TNK-BP], *Open Russia*, 8 June 2016, accessed at <https://openrussia.org/post/view/15547/> on 30 August 2016.



ergy, real estate and telecommunications. Recently Fridman announced that he is planning to invest an additional \$3 billion of Rosneft's money in US health care and is expanding his lobbying presence in Washington, DC.⁴⁷ Both Usmanov and Fridman have invested in Uber in the last eight months.⁴⁸

It is interesting to highlight what style Fridman has chosen for the endorsement of the Kremlin's actions. In November's interview with the Russian glamour magazine *Snob* and in other media publications, Fridman put forward the idea that he and his partners have not been against or in favour of political decisions: these are matters for the politicians and power brokers. His team is made up of non-partisan and apolitical business people who have no interest in or influence over policymaking, and no interest in changing or even commenting on the Kremlin's aggressive adventures abroad.⁴⁹

This is quite paradoxical, given that Alfa-Bank has provided credit lines to Atomstroyexport (the entity that worked on Iran's nuclear program)⁵⁰ and Uralvagonzavod (a plant that produces around 40% of military equipment in Russia, including arms that are now used in Ukraine and Syria). In the last three years, Alfa has also hired the following people to front its key companies in Russia and in the West: Alexander Vinokurov, son-in-law of Foreign Minister Sergey Lavrov, as CEO of A1, the main operational unit of Alfa; Maria Faassen, older daughter of Putin, at Alfa-Endeo, an Alfa-sponsored subsidiary; and Franz Wolf, son of the ex-director of GDR's Stasi.⁵¹ All of this suggests close links with the regime and its security apparatus.⁵²

⁴⁷ I. Reznik and A. Sazonov, 'Russian Oil Billionaires' Next Big Investment—American Health Care', *Bloomberg*, 14 July 2016, accessed at <http://www.bloomberg.com/news/articles/2016-07-14/russian-billionaires-plan-u-s-health-push-with-d-c-insiders> on 30 August 2016.

⁴⁸ S. Clark, 'Mikhail Fridman's LetterOne Invests \$200 Million in Uber', *The Wall Street Journal*, 12 February, accessed at <http://www.wsj.com/articles/mikhail-fridmans-letterone-invests-200-million-in-uber-1455287192> on 30 August 2016.

⁴⁹ N. Uskov, Михаил Фридман: Я наслаждаюсь тем, чем я занимаюсь [Mikhail Fridman: I Enjoy What I Am Doing], *Snob*, 2 November 2015, accessed at <https://snob.ru/selected/entry/99294?v=1454576707> on 30 August 2016.

⁵⁰ T. Palmeri, 'NY Jewish Leader's Biz Partner has "Iran tie\$"', *New York Post*, 9 April 2012, accessed at <http://nypost.com/2012/04/09/ny-jewish-leaders-biz-partner-has-iran-tie/> on 30 August 2016.

⁵¹ L. Gürtler and J. Webermann, Deutscher Helfer für russischen Oligarchen [German Aid for Russian Oligarch], *NDR*, 10 April 2013, accessed at <http://www.ndr.de/home/offshoreleaks213.html> on 30 August 2016.

⁵² S. Grey and E. Piper, СПЕЦИАЛЬНЫЙ РЕПОРТАЖ—Старшая дочь Путина—биомедик [Special Report—The Eldest Daughter of Putin is Biomedical Scientist], *Reuters*, 11 November 2015, accessed at <http://ru.reuters.com/article/topNews/idRUKCN0S2VL20151110?sp=true> on 30 August 2016.



Oligarchs' public endorsement of Putin and his policies varies from outright flattery to anecdotal conclusions on Eastern–Western relations, but the question of visible loyalty to the regime is one thing that is constant. Thus, as soon as the war in Ukraine started, Gennadiy Timchenko fully relocated to Russia and said in an interview that he gave his full support to the president. He emphasised that no one in the West should hope to drive a wedge between entrepreneurs and authorities. However, even such a Putin loyalist as Timchenko has reportedly been lukewarm to participating in the construction of a bridge from Russia to Crimea, as there was not enough state investment behind it.⁵³ The Rotenberg family had to reluctantly take the project on board just as the family lost the status of being the richest in Russia.⁵⁴

Recently, the project was delayed further⁵⁵ and will likely face more cost increases. At the same time, estimates of a deteriorating business environment for the Rotenbergs might be premature, as most recent reports of Arkadiy Rotenberg's StroyGazMontazh show that the construction company's profits doubled in 2015.⁵⁶ It looks like state contracts help Putin's friends to keep afloat.

Vladimir Potanin flattered Putin in mid-2015 by saying that the Russian president has a stronger mandate and more popular support than do his Western counterparts and that Russians will wait out Western-imposed sanctions, as their pain threshold is higher.⁵⁷ However, even with that flattery and disclaimers that sanctions were waning and do

⁵³ Мост через санкции Как Тамань готовится к строительству Керченского моста. Репортаж Ильи Жегулева [Bridge over Sanctions. How Taman Prepares for Construction of Kerch Bridge. Report by Ilya Zhegulev], *Meduza*, 10 August 2015, accessed at <https://meduza.io/feature/2015/08/10/most-cherez-sanktsii> on 30 August 2016.

⁵⁴ Ротенберги потеряли статус богатейшей семьи России [Rotenbergs Lost the Status of the Richest Family in Russia], *Secret Firma*, 20 August 2015, accessed at <http://secretmag.ru/news/2015/08/20/rotenbergi-vs-guceriev/> on 30 August 2016.

⁵⁵ СМИ узнали о срыве конкурса на строительство подходов к мосту в Крым [Media Found out about Disruption of the Competition for the Bridge Approaching Crimea], *PBK*, 2 August 2016, accessed at <http://www.rbc.ru/business/02/08/2016/57a047799a7947c37e8a9b0f> on 30 August 2016.

⁵⁶ 'Стройгазмонтаж' Ротенберга по итогам 2015 года удвоил прибыль [The Profit of Rotenberg's Stroygazmontazh has Increased in 2015], *Interfax*, 3 August 2016, accessed at <http://www.interfax.ru/business/521785> on 30 August 2016.

⁵⁷ Потанин рассказал о болевом пороге россиян и доверии Путину [Potanin Discussed Russians' Threshold of Pain and Trust in Putin], *Lenta.ru*, 6 July 2015, accessed at <https://lenta.ru/news/2015/07/06/potanin/> on 30 August 2016.



not work, Potanin said that two sides should inevitably find peace and some form of mutual agreement.⁵⁸

The same line about the inefficiency of sanctions was repeated by Mikhail Prokhorov, who also said in spring 2015 that the annexation of Crimea was the biggest event of the twenty-first century and he is undecided about it.⁵⁹ As I have pointed out, despite mild criticisms Prokhorov remains loyal to the regime and useful for the Kremlin. Prokhorov's sister, Irina, has recently announced that she might run in parliamentary elections in September 2016 and even in the 2018 presidential elections. Her brother's candidacy in the 2012 presidential elections acted as a spoiler against opposition candidates. It is likely that in the parliamentary elections in September, Prokhorov might again serve a useful function for the regime by propping up an artificial party, now headed by his sister.

The bottom line is that, despite considerable financial losses, no oligarch is even remotely ready to challenge Putin's policies in public, and loyalty to Putin remains the main asset. However, when feasible, oligarchs would like to get state support and avoid incurring costs even for patriotic cases. All oligarchs have to repeat official propaganda on the ineffectiveness of US–EU sanctions. However, most of those with links to the Europe and the US tend to move discourse towards reconciliation and normalisation of relations with the West.

Conclusions

The following conclusions can be drawn from what has been said about the impact of the crisis on Russian oligarchs and the broader business community.

A perfect economic storm based on the original inefficiency of state capitalism (fully present before 2014), falling commodity prices and the impact of sanctions has hit hard both the wealthiest entrepreneurs and

⁵⁸ R. Chilcote and Y. Fedorinova, 'Russia's Richest Billionaire: Impact of Sanctions Is Waning', *Bloomberg*, 18 May 2015, accessed at <http://www.bloomberg.com/news/articles/2015-05-18/russia-s-richest-billionaire-says-impact-of-sanctions-is-waning> on 30 August 2016.

⁵⁹ Прохоров назвал введение санкций против России «неэффективным» [Prokhorov Called the Sanctions Against Russia 'Ineffective'], *Rbc.ru*, 13 May 2015, accessed at <http://www.rbc.ru/rbcfreeneews/5502da399a7947cd5a0a6d66> on 30 August 2016.



those who are less wealthy. Smaller businesses have reacted to the worsening business climate and sanctions by taking serious austerity measures and/or by going into a shadow economy, as in the 1990s. Larger businesses and oligarchs with connections to the state have found ways to adapt to the crisis and sanctions via asset transfers, state subsidies, use of second-tier banks and other mechanisms that circumvent sanctions.

The Russian business elite remain compliant with the major economic and warfare spending policies of the government. The elite are not divided. They remain dependent on political and economic support from the Kremlin. The oligarchs do want to trade with the West and hope for reconciliation. But they make sure that they publicly take the official Russian line of scepticism about Western sanctions and the genius of Putin's decision-making.

Western sanctions remain quite superficial in the sense that they have not been able either to change the Kremlin's policy in Ukraine or to create any divisions among the elites. Instead, the existing sanctions have merely sent a signal of what else Russia can expect if it advances further in Ukraine, beyond its eastern regions.

The sanctions have contributed to the economic downturn in Russia and created a chilling effect for Western investments in all Russian entities, even beyond a relatively narrow list of the few dozen companies directly sanctioned. However, they have not reversed the course of the economic mobilisation of the Kremlin, whereby the government allocates fewer financial resources in the country without a significant impact on the current military and secret service policy and operations. It is likely that the impact of even relatively superficial sanctions, combined with the economic downturn and low commodity prices, will shrink the Kremlin's available resources even more in the longer term and thus may impact its aggressive foreign policy. But this could take years, if not decades.

As for the oligarchs, the sanctions cover fewer than ten really wealthy individuals around Putin. The overwhelming majority of both those on Russia's Forbes list and the country's unofficial billionaires and millionaires have been left untouched, a group that includes top power brokers and vested individuals. In that sense, the sanctions miss the target of dividing the elites, as Putin has found enough political and economic resources to keep the inner group of sanctioned cronies flush with



state contracts. Non-sanctioned oligarchs are also kept at bay and loyal through a variety of carrot-and-stick policies. It is likely that Putin has highly compromising material on the wealthiest oligarchs and officials, while at the same time he tries to lure them through not only tacit blackmail but also state contracts, tax breaks and other forms of subsidies.

Western policymakers understand that they can only weaken the loyalty of a large group of oligarchs quickly by expanding the individual sanction list to include hundreds of individuals and/or by large-scale sector-wide sanctions (e.g. a ban on Russian oil and gas exports to Europe, like the one imposed on Iran). However, in doing this, the White House (the leader in the sanctions regime), and to a lesser degree European capitals, would risk escalating the conflict with Russia over Ukraine and still other matters and pushing the Kremlin to adopt a besieged-castle policy and even to mobilise for war. Thus, the current policy of relatively superficial sanctions is a compromise between total appeasement and further escalation of the conflict with Russia. It appears that the West is betting on the long-term game of patience and the slow strangling effect of mild sanctions—that are unlikely to bring about a change in the regime’s policies until several years have passed, and perhaps even a decade

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