

The Foreign Policy Centre



The European Think Tank with a Global Outlook

KREMLIN ECHO: THREE VIEWS ON PRESIDENTIAL POWER, LAW AND THE ECONOMY

January 2005

First published in 2005 by
The Foreign Policy Centre
49 Chalton Street
London NW1 1HY
UNITED KINGDOM

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ISBN: 1 903558 51 4

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Acknowledgements

This pamphlet is built around the text of an interview given to a Moscow radio station, *Ekho Moskv*y (Moscow Echo) by Andrei Illarionov (Illarionov). The interview as published here has been translated by the Federal News Service and has been reprinted by permission of the Federal News Service and of *Ekho Moskv*y Radio. The interview has not been printed in full.

Andrei Illarionov is an Economic Advisor to Vladimir Putin, the President of the Russian Federation, and was his Personal Representative for the G-8 until 4 January 2005. Since his appointment as the President's Advisor in April 2000, Illarionov has been on leave from the post of the Director of the Institute of Economic Analysis, an independent economic think-tank in Moscow and one of Russia's leading liberal economic research centres. Dr. Illarionov has a PhD from the University of St. Petersburg. He has co-authored economic programmes for several Russian governments, and has written three books and over 300 articles on Russian economic and social policies.

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Preface

If the political ambitions of one man — the Russian oligarch Mikhail Khodorkovsky — were the initial justification for the Kremlin's clampdown on the oil group Yukos, the final victim has been much bigger: the country's entire tentative shift towards the rule of law.

There is no doubt that during the 1990s, Khodorkovsky was widely criticised for playing fast and loose with Russia's weak laws — and its still weaker lawmakers and implementers — in his efforts to take full control over the company.

A rise in oil prices and a Damascene-style change in tactics since 2000 may not mean his subsequent motives were more pure or his future practices forever enlightened, even as he turned the company into a darling of the stock market and a symbol of the new revitalised Russia.

But do his past aggressive business practices during a particularly chaotic period in Russian history justify yet one more change of property ownership, this time back from a questionable privatiser into the hands of the state or its proxies, who are even less likely to manage it effectively or transparently?

As one Moscow investment banker put it to me recently: 'There is always the justification in Russia for one more transfer of ownership'. The result is continued instability, lower investment, and economic growth below the levels of the country's needs and potential.

The dubious legal tactics employed by the state in the Yukos saga have reached unprecedented heights: lengthy detention without trial; alleged use of drugs in interrogation; search and arrest of defence lawyers; 'fishing expeditions' to gather documents; intimidation and harassment of witnesses and their families.

Vladimir Putin, himself a lawyer, began his first term pledging the introduction of the 'dictatorship of the law', after a period of

undisputed widespread abuse. He made a promising start, with a necessary restructuring of the judiciary accompanied by greater funding, higher salaries and the development of new legal codes.

It now seems clear that the 'dictatorship' is playing a greater part than the 'law'. Judges have been brought back more closely under the Kremlin's control, and in the phrase of some specialists researching the subject, the shift has been towards rule BY law instead of rule OF law.

If this maxim applies in criminal cases, it is equally relevant to commercial ones. In late 2002, officials criticised the use of 'front companies' in the rigged privatisation auction for the state-controlled oil group Slavneft, and banned the state company Rosneft from participating.

Almost exactly two years later, after dubious tax demands so high that they exceeded Yukos' total revenues, the company's prize subsidiary Yuganskneftegaz was sold in a similarly rigged auction via an obscure front company to that same Rosneft — at well below the market price.

The only redeeming aspect of the state's tactics throughout the saga is that the expropriation has so far been rather less violent than the bloody legacy of confiscation in the name of the people in early Soviet times.

If Yukos was a one-off, it might be unpleasant but not raise broader policy concerns. In fact, there are signs that it is only the most recent and high-profile instance of a far broader trend.

Sir John Browne, the head of BP, discovered the dangers in the late 1990s when he was almost forced to write off an investment he had made in the oil group Sidanco, after being caught between two oligarchs fighting for control. As he memorably put it at the time: 'Russia is a country ruled by men, not laws'.

That phrase stands today. Sir John has been able to use it to his advantage, since his clout as head of one of the world's largest oil

companies has allowed him to by-pass unreliable systems and officials, and negotiate directly with the leaders of the UK and Russia. But that does little to help improve the climate for other investors.

It is important not to forget the Russian context. In pre-revolutionary, Communist, and post-Soviet times alike, there was little tradition of rule of law, private property rights, or independent institutions. The whim of the Tsar and the intrigues of the boyars have always held greater sway than abstract ideas of justice.

Putin has also had to reassert his power over a broken system. His instincts are to revert to the instruments that he knows best: the police, prosecutors and tax inspectors. Yet, in these agencies, even more than in other parts of the civil service, the best employees have left, leaving rather less subtle ones behind.

Putin may have less room for manoeuvre in the Yukos affair than his critics sometimes imagine. But now, as he moves into the fifth year of his presidency, he must take responsibility for what has taken place. And his personal influence – whether marginal or great – has been employed in a worrying direction for those hoping for a fairer, more sustainable future for his country.

Andrew Jack
January 2005

RADIO INTERVIEW WITH PRESIDENTIAL ECONOMIC ADVISER ANDREI ILLARIONOV

**EKHO MOSKVY RADIO, 16:00, 30
DECEMBER 2004**

Anchor: Our well-informed interlocutor today is adviser to the President of the Russian Federation Andrei Illarionov. Good afternoon.

Illarionov: Good afternoon to you and to our listeners.

Anchor: Right off, you can put questions to Andrei Illarionov by calling . . . Ekho Moskvyy. Moreover, we have agreed that even if we don't have time to answer all your questions, we have agreed with Andrei Nikolayevich that all the questions will be printed and conveyed to him and all the answers will be posted on his website. So, don't be backward in coming forward. And the same goes for the Internet. By the way, Andrei, I had a plan, before your famous press conference, to have you on a broadcast called 'The Lessons of 2004 and the Threats of 2005'. There is much talk now at the Kremlin about political and economic threats. By the way, at 16:35 we will have the Ricochet program which will look at your opinion regarding what a high-ranking official should do if his advice is perceived as it is.

Before we pass on the substance I would like to convey some questions from our listeners. For example, a white collar worker named Alexander, from Moscow, writes: Who has permitted you to speak about the state of our economy in such sharp terms and the causes of such a state? Is it just an exercise in letting off steam?

Illarionov: First of all, I would like to thank your listeners . . . for asking a lot of questions. I understand that these questions continue to arrive. I have seen some, but not all of them. They are still coming in. But I promise that I will read them all and I will try to answer some of them during our broadcast and I will try to find other ways to answer at least the most frequent questions. Secondly, I would like to thank our listeners and Ekho Moskvyy for the opportunity to organize a unique kind of opinion poll in our society regarding what is happening in this country, the assessment of the events and what the 'high-ranking officials' should or should not do.

Secondly, I would like to thank Ekho Moskvyy for repeatedly taking up the topic of the goings-on in our economy, along with other radio stations, about what is happening to some high-ranking officials in charge of the economy, their advice and perception of the advice.

Anchor: Then on who is letting this happen.

Illarionov: My understanding of what is happening lets me do this, as well as the fact that in the past around 20 years I have rather professionally dealt with economic issues, economic policy issues, and my education my university gave me, along with my friends and colleagues. Life does not only let me. It makes me do what I am doing. Besides, my position, my job lets me do this. It is the position of the Russian President's adviser. This means that I should advise to the President. As this is a state position, I have to advise to the authorities in general and the country in general on what should be done, what can be done and what should not be done under any conditions.

Anchor: There was such an implication: are you the smartest one here?

Illarionov: In this part, I have to say that I have performed my office duties when saying things that have been noticed by various people recently.

As for smartness, I think it would be extremely dangerous if someone in the country decides that he is the smartest one and

stops listening to other people. The thing is that the country's success does not depend on whether there is one smartest individual who should be elected or appointed so he would be responsible for anything and would have the right to neglect any other opinions. The smartness of a leader and the authorities in general is that they should not turn a blind eye to what is really happening in the country, should not stop listening to opinions voiced by the people, should not neglect people's reaction to what is happening.

Therefore any steps aimed at limiting feedback in society are very dangerous. As for feedback, it is a political system, election, including of regional leaders, freedom of the mass media and freedom of speech, freedom of expressing various points of view in the mass media, freedom of discussing any, including unpleasant issues faced by society. The rejection of that freedom, the rejection of the opportunity to discuss most important issues is dangerous to the country, to society.

Anchor: Andrei Nikolayevich, some of our listeners reproach you for having done this publicly. As they see it, you are adviser to the President and your business is to advise him and it is up to him to heed or disregard your advice. But to disclose your differences with the president, and express your dissatisfaction with the activities and the position of the president -- many of our listeners think that this is not the way a civil servant should behave.

Illarionov: First of all, I appreciate our colleagues for advising the adviser. I follow the advice attentively and I try to make use of their advice in my work. I am not sure that other government servants get as much advice, but at least I try to read all the advice that is sent to me and use it. As to whether one should advise silently and not make any public statements, I must say that the work of a government official by definition should not be secret. There is the secret part of his duties and there is the public part. I think it is very dangerous if people holding state office become totally secret and silent and society does not know what they do, does not know their opinion on certain issues and has no way of judging them.

I think it is an inalienable part of democratic society that citizens should have an idea about the views espoused by holders of government office.

Anchor: We will go back to all these issues in our Ricochet program, but first let us start with the severe lessons of 2004. For some reason, I find it strange that 'events in Ukraine' provided one of the lessons of the year. What sort of lesson is it for Russia and what conclusions should be drawn in order to learn?

Illarionov: Yes, I have said that the main lesson is Ukraine, only not 'the events in Ukraine' but 'the revolution in Ukraine' because what happened in Ukraine can only be described as a revolution. It is a revolution, a victorious revolution. In that case, people who have adhered to a certain position and initially showed their position in a mass movement and then won a victory in an open, fair and tough political struggle, including via the election. In my opinion, this is an important lesson for us, not just for Ukraine.

Anchor: For us.

Illarionov: Yes, for us.

Anchor: Why?

Illarionov: As our colleagues have noted already, and I have to say this: I am an economic adviser and I have dealt with economic issues first and foremost. Still, certain trends in our political and social life cannot leave anyone indifferent, economists included. Those trends are related to the liquidation of a whole range of institutes of society responsible for feedback. I listed them already. They are the mass media, democratic institutes responsible for conveying signals, including signals about unfavourable developments, signals about crises, about catastrophes to the society and to the authorities.

Amputation of those institutes leads to catastrophic consequences for the whole society, for the country on a scale substantially exceeding what could have happened had this system worked

openly. Because, in that case, problems are not resolved, they tend to accumulate and sooner or later they are directed at the centre of the political system. Such crises are not resolved through elections, and a revolution in the streets offers a way to resolve such crises. If there are no normal, traditional, legal ways to resolve crises, there is no other way out but the revolution.

Anchor: Do you mean that we can arrive at such a situation?

Illarionov: We will inevitably arrive there, if the trends we have today prevail and if we are unable to overcome those trends. Even in current conditions -- by the way, this is very important -- the country does not have, it is having rapidly liquidated the system for conveying signals about an unfavourable situation to power bodies. It is an extremely dangerous situation, more dangerous than the worsening of the quality of economic policy, more dangerous than any other things we were talking about because the scale of the disaster is not to be compared even with the mistakes that have been made in the outgoing year. Let me just give you one comparison that will readily appeal to everyone: the tsunami in Southeast Asia and South Asia. Lack of a system of earthquake and tsunami warning resulted in a colossal human toll. But in the United States such a system of warning exists.

Anchor: In Florida –

Illarionov: There were four gigantic cyclones, and a hurricane that caused colossal devastation, they hit the coasts of Florida and Texas and claimed some lives. But several tens of people died there. In neighbouring Haiti, where the hurricane had the same power, several thousand people died. This is the difference of price: the existence of a monitoring and warning system and the lack of such a system.

Many Asian countries don't have a warning and monitoring system. The result is a colossal number of deaths. The same is true of the economic, social and political systems. The fact that we have an elected parliament, competing parties, the possibility of choosing governors, a free media, exchange of opinions and public debate,

including the debate that we used to have and that is now absent on Channel 1, on NTV and other channels -- the lack of such a system, the dismantling of a system of monitoring and warning --

Anchor: You are talking about a social warning system?

Illarionov: Yes, of course. Because democracy actually is a system of monitoring and preventing disasters because people, in discussing all this, detect problems at early stages. It is not a perfect system and it does not always yield the desired results but it exists. The liquidation of the system means that any, even a small conflict, may have disastrous consequences. By the way, we have seen it in some republics here, in the North Caucasus.

Anchor: Let me put the question in another way. Reports today speak about the sequel to the affair connected with the merger of Gazprom, Rosneft and Yuganskneftegaz. Let me remind our listeners that Yuganskneftegaz, purchased by Rosneft, will become a separate state-owned company, 20 percent of which may be offered to the Chinese national company. We have already lost track of the poor Yugansk which keeps changing its name. Andrei, what does it prove?

Illarionov: It proves two things. First, the Yugansk sale and the mergers and break-ups of various companies have a very strong claim to being called the Affair of the Year. And in fact, it continues. So, it has a chance of becoming an affair of more than one year.

Secondly, it proves -- these recent decisions prove -- that very small elements of that system of monitoring and warning have still remained, partially in this country and partially abroad, such as the Texas court in this particular case. In this particular case, this is a monitoring and warning system that works for us, for our benefit. Had there been no Texas court, we should have invented it, because in this particular case it works for us, for our country.

Anchor: Please, explain.

Illarionov: They are warning us about catastrophic effects of certain decisions. Had the Texas court failed to make its decision then, had it made it slightly later, and operation related to Rosneft's takeover of Yuganskneftegaz would have happened and Gazprom would have taken over Rosneft. Suits filed against the companies involved in those deals could have resulted, in particular, in suspending a whole range of contracts to which Gazprom is a party, which is our biggest company. In that case consequences for our country would have been different from those in the Noga case.

So, we should just thank the Texas court and the judge for having done everything possible to help Russia avoid falling into the abyss they have pushed us to.

Anchor: You said this is the first thing.

Illarionov: The second one, because the first was that I said that it is a swindle.

Anchor: Well, as a Kremlin official said in an interview with Vedomosti when asked to comment on the word 'swindle', he said: Well, Illarionov is an economist, and Putin is a lawyer. Lawyers better understand the meaning of the word. So, what do you mean when using the word?

Illarionov: I mean that steps have been taken which have dealt substantial, huge losses to the country. Those steps have been accomplished in a very unprofessional manner. Perhaps it is good that they have been made so incompetently and unprofessionally, because it is clear to everyone that they are just guided by their willingness to seize property, private property. This is expropriation of private property, and this can only be described as a swindle. We have gone through a very hard and painful period over the past century. We know what expropriation of private property means.

We know it not from textbooks. We know from our country's history what consequences, some bloody consequences this leads to.

Anchor: I have a question that I can't help asking. When all this was unfolding, did you present your point of view to the country's leadership in the same terms as you are doing now or perhaps even in still more blunt terms? Many people have conveyed their views, but did you convey your point of view to the president?

Illarionov: Neither you nor any of our listeners should have any doubts that the president's adviser has many ways of getting his views across to those who take decisions.

Anchor: Welcome to Rikoshet program with president's economic adviser Andrei Illarionov. Many of our listeners have advised the adviser, to quote Andrei Nikolayevich, either to quit or to shut up, to put it crudely. So, we decided to ask you a question that may apply to Andrei Nikolayevich, but also to other high-ranking officials finding themselves in such a situation. What should a decent person do in such a situation? Put yourselves in his place. Should he stay on in order to try to exert influence, advise and comment or to quit and thus stop exerting influence, advising and commenting. . . The voting will last four minutes and the call is free if you are in Moscow. . .

While the vote is under way, Andrei, one of the events of the year that many newspapers have noted is the dramatic strengthening of the ruble and the fall of the dollar. Is it good for the country, for the individual citizen, a member of the middle class who has small savings which many people in this country keep in dollars?

Illarionov: The consequences fall into two parts.

Anchor: We are talking about the dollar and the ruble.

Illarionov: The dollar, the euro and the ruble.

Anchor: The dollar and the euro.

Illarionov: For many of our citizens who kept their savings in dollars and have got used to the dollar in the last 13 years as a result of the hyperinflation that we had over a long period it means a substantial loss of savings.

Over the past four years, from October 2000 the dollar dropped by 60 percent against the euro, and accordingly, the dollar savings lost about as much in purchasing power.

The citizens who still keep their savings in dollars face a serious question: Should they go into euros or rubles –

Anchor: Get rid of dollars.

Illarionov: Get rid of dollars and so on. It depends on which way the dollar will move, and not only over the next few weeks or months. But in the longer term.

Anchor: A year or two?

Illarionov: If the dollar continues to fall, then, of course, one should go out of the dollar like any asset that is losing its value. If the dollar bounces back, then one shouldn't go out of the dollar because the dollar may be cheap now but then it will become more expensive and the worst thing would be to exchange your currency when it has reached its lowest point.

The problem is that no one -- I stress -- no one can predict in what direction the dollar will move, whether it will continue to fall or will start climbing. Opinions on this matter differ. There is no consensus among economists on this. So, the decision is up to the citizens themselves.

Anchor: . . . Andrei, what are the implications for the country?

Illarionov: The implications for the country also fall into two parts. The first is the dollar denominated obligations of our country, that is, our foreign debt is denominated in dollars. So, the fall of the dollar means that the purchasing value of the debt is falling and it is not accidental that this year our foreign debt diminished not only because we are paying it off, but also because the dollar is falling. And of course, for us it is all on the plus side, because we have to pay less toward our obligations.

Anchor: So, we should quickly pay off our foreign debt while the dollar is at its lowest point?

Illarionov: Absolutely. This is what we have been saying for the last five years. Taking advantage of the very favourable market situation, including the deviation of the dollar from its long-term trend, taking advantage of the fact that we are earning huge revenues and of this exchange rate in order to pay much of our foreign debt which is denominated in dollars. It costs us much less. This is really a saving of hundreds of millions, if not billions of dollars today.

There is a different aspect related to the dynamics of the real economy. As the dollar declines, the euro grows respectively, and our main trading partners are in Europe and have either euro as a currency or currencies pegged to the euro. Therefore, we get additional support for our competitive capacity, and our economy continues to grow, even if slowly, even if unsteadily, but it continues to grow, including for that reason that our goods are still competitive in the European markets.

Had the currency ratio been different, that is, had the dollar grown and the euro declined, we would have found ourselves in a much graver economic situation. Economic growth would have most likely discontinued long ago. In that case we would have suffered a serious shock in what concerns our real economy. And citizens would have asked questions not just about their savings, but also about their wages and their jobs, because a slowdown in economic growth would have immediately influenced the number of jobs, work pay and would have brought a whole range of enterprises to a state close to bankruptcy.

Anchor: So, our vote is over. We have received 9,283 calls, quite a lot. The highest number of calls we received was when we asked a question on Stalin, not on decent people. It was also in the evening, and there were 10,000 calls. So, we are now only slightly behind. Andrei, your opinion, what is the vote distribution in percentage terms?

Illarionov: There was a question some time ago about whether I am the smartest one or not. I believe that the people in general are the smartest one, because they have different points of view, rather than the only one. It is always important under any conditions not to be too conceited and think that you know better than the country and the people know. One should listen to what people advise.

Anchor: So, let us listen to what they say. Do you promise to act in line with the results?

Illarionov: No, I promise to take this into account.

Anchor: Okay. We have received 9,283 calls. The question was: what should a decent person do in such a situation? Stay to try to influence and advise or go to stop influencing and advising? 86 percent said, one should stay to try to influence, advise or comment, 86 percent. The meaning is perhaps that let those who want it sack this decent individual. Why should one do this work for them? This is their job. Well, we have received the answer.

Illarionov: First, I would like to thank all of our listeners, those who have called and given various advices, those who have given either answer, because in both cases there is a system of arguments explaining why one should behave this or that way.

So, I am grateful to all of you and I promise that I will certainly take account of both points of view.

As for resignations and dismissals, in connection with the fact that there have been lots of comments, I would like to say the following thing. Anyway, no matter what I do or what they do about me, I find it important to say that those who deal a blow to the Russian economy should step down, those who lead to such a situation when our country is more vulnerable to crises and catastrophes as the early monitoring and warning system is liquidated.

Anchor: Well, perhaps you meet with them in the lobby. You could give them advice of that kind.

Illarionov: I find it particularly important that not only those who work there should advise, but also those who do not work there. I think that we need to make sure that this country should advance, perhaps, not as fast as we would like it too, but it should advance in the right direction. Certainly it would be better if it moved faster. The authorities in general, like separate officials, should listen to what people say.

Anchor: Andrei Nikolayevich, another question. I wanted to ask you about next year's threats. In connection with latest reports, we know that the main threat, perhaps not the main one, yet very important one is the threat of terrorism. Unfortunately, it has not decreased.

In this connection, many state officials, public servants have proposed various ways for dealing with the threat. In particular, as far as I understand, Defence Minister Sergei Ivanov has said that any postponement of military service for young people should be scrapped. Next year the Defence Ministry will mostly likely submit this proposal. I would like to know your opinion within your competence, because those who object to Sergei Ivanov have spoken about losses due to this for the country's economy, for the country's development.

Is it possible to weigh which is more important? Should we really temporarily scrap any deferments because security is more important and nothing bad will happen to the economy?

Illarionov: You know the country's security, including external security, is very important. There are the armed forces for that. And the economy is extremely important because only the economy can create the economic foundation for ensuring security. In the modern world, security has been ensured not only and not so much by human masses, but also the quality of servicemen, their equipment, weapons, and only a combination of all those factors can ensure the highest rate of economic development and the highest rate of national security.

So, mobilisation of as many people as possible is a characteristic feature of countries at a different stage of development. They are

mostly agrarian, patriarchal countries with very low development levels and too much agrarian population. Different armies are required for modern countries with a high economic development level, at least countries willing to be such countries. They need small, mobile, well equipped, high quality armies with a high educational level of those serving in the armed forces. Only such armies can ensure high level of security for their country.

So, the debate itself is very important, because it concerns hundreds of thousands of people in this country. Still, in my opinion, this is a problem of yesterday, because only a professional army can guarantee our country's security, can guarantee security to a country we want to live in. Therefore, all that talk about deferment from army service, as well as comprehensive military duty, is an element of armies of yesterday and the day before yesterday. With or without postponements. But this certainly influences the fates of many people. If we really want to be a modern country, we should create a modern professional army.

Anchor: Along with other things, this is economically beneficial...

Illarionov: First of all, this ensures the security level required today. Naturally, this is a required precondition for successful economic development.

Anchor: A question from Ulyanovsk. A lot of people have discussed the Stabilisation Fund, ways for spending the money. Living standards are low and they are the lowest in remote areas.

So, Vladimir Martsinkevich, a journalist from Ulyanovsk writes: 'I believe that the Stabilisation Fund's money invested by our government in American companies has just been stolen from us.' What is your opinion?

Illarionov: The thing is that the Stabilisation Fund's money has not been invested in American companies and will not be invested in American companies. Stabilisation fund money is invested in the government securities, including US treasury bonds, possibly the securities of some European states, especially Germany. These are

thought to be most reliable securities that command confidence. If Russian securities, including those reflecting the Russian debt had a credibility approaching that of the European securities or American ones, then other countries could invest in this paper. But because of the economic policy we have pursued, because of the credibility gap, nobody is investing in them. These are our actions.

Anchor: Why did you say at the press conference that you think that the stabilisation fund money should be spent only to repay the foreign debt? Many questioners are wondering whether perhaps some of this money should be spent -- for example, people are afraid to be losers as a result of the monetisation of in-kind benefits. After all, the fund is huge, billions of dollars. Why not support people even psychologically in this transition period?

Illarionov: If we do this even the economic growth that we have -- and it proceeds at a snail's pace -- even that growth will grind to a halt and a slump will begin.

We have spoken about the ratio between the dollar, the euro and the ruble. If stabilisation fund money is called stabilisation and stabilise only against the flood of dollars that came down on our economy and threatens to crush our economy -- if we start spending the money of the stabilisation fund inside the country for whatever purpose, it will be crushed and then we may feel that we are solving problems, but actually the economy will be stagnating or even falling.

Many countries have found themselves in such a situation and the consequences will be catastrophic. If we want to develop not only today, but tomorrow and the day after tomorrow, and in the long term, the money that was actually windfall money, should be spent to liquidate the debt that has accumulated. We will liquidate the foreign debt and so neither we nor our children nor our descendants will have to bother about paying this debt. And it remains to be seen what the situation in the market will be. Nobody has said that the current situation will last indefinitely.

Anchor: A question from Anyuta: 'What sense is there in forgiving the Iraqi debt? We are repaying our own and forgiving the debts of others.'

Illarionov: My view is that it made no sense.

Anchor: So, you were against forgiving the debt?

Illarionov: Yes, I was.

Anchor: Can you give the reasons?

Illarionov: I can tell you why. Yes, Iraq is not a poor country. Iraq is a medium-level country even now. Secondly, Iraq is a country that has the world's second biggest oil reserves after Saudi Arabia. It is already not the poorest of countries, and potentially it is one of the richest countries. Even when you forgive debts to poor countries, you should think about the result because, very often, it corrupts the countries that receive credits and do not pay them back. Still less reason, economic and moral, not only from our point of view, but from the point of view of the countries that are borrowers, to forgive the debts to medium-level and rich countries. Iraq is one of the richest countries in terms of natural resources which potentially can have hundreds of billions of dollars in currency earnings. So, from the economic point of view it should not have been done.

But the decision over the Iraqi debt, like some other decisions, was taken out of political considerations and not economic considerations.

Anchor: Our time is running out, and people, our listeners are worried that the monetisation of social benefits will make big holes in their family budgets. This monetisation is beginning and the money will flow into the internal market. It means payments in hard cash. What could you tell these people? Could you give advice for the people who will have their in-kind benefits replaced by cash payments?

Illarionov: I can't give them any tips.

Anchor: But they are worried.

Illarionov: I would just draw your attention to what the Minister of Social Development, Zurabov, said at a recent government meeting. He said that at the start of the monetisation the volume of these in-kind social benefits was estimated at 50 billion rubles. But after all the 'sleeping' benefits, people never availed themselves of were recalculated it turned out that the budget has to be increased to 200 billion rubles, that is, four-fold. And now this figure of about 200 billion rubles is in the federal budget and in the budget of the Pension Fund and some other budgets.

So, as a result of the monetisation of benefits the real amount of money to be paid out to citizens has increased at least by four times. Clearly, for every concrete individual the ratio between the amount the person receives may be different from what he used to get last year or in the previous years.

Still, it is clear that in this particular case the amount of revenues for the country's citizens has grown substantially. This is the problem and this explains why quite a lot of people have so negatively perceived this monetisation of benefits package.

Anchor: They have fears.

Illarionov: They also fear expressing their views on the issue, including negative views. In my opinion, it is necessary to explain what is being done and in what way this is being done. So far, this has not been done properly, in my opinion. People do not understand and they are afraid of being deceived, they are afraid that it will be worse, because unfortunately our previous record gives a lot of examples of the way this is happening.

Frankly, it is impossible to give any guarantees that everything will be done properly and accurately. On the other hand, I would like to say that strategic motives behind the monetisation of benefits are absolutely right. Lots of people have doubts and worries, but this is the right approach in strategic terms.

It is important to do this properly for people to know what they will get, what rights they have and what way they will get the money as a result of those decisions.

Anchor: Andrei, the New Year is approaching and I would like to tell our listeners, including those who voted today on our question, as to what good they may expect next year. What good and optimistic could you tell them? Or what warning would you like to convey to them?

Illarionov: You know, Professor Preobrazhensky once said that disorder in the streets starts with disorder in the heads. I would like to wish all of us, myself and my colleagues, including those in power, those who make decisions that are fateful to the country and millions of people to start getting rid of disorder in their heads, start doing away with being too conceited, start doing away with the belief that they know better no matter who they are, start doing away with the belief that they can neglect the opinion of the people.

I would wish all of us to start doing away with inadequate ideas about the world around us, both in this country and in other countries. We should try to see what is happening in other countries, how they develop, how fast countries surrounding us develop. We should get rid of inadequate ideas about our place in the country's life and history and of inadequate ideas about effects of our moves.

If we engage in a permanent dialogue with the country -- actually, people should have a chance to influence decision-making and voice their views, and we should hear them, and they should hear us, so it would be a permanent dialogue. But it should not be a monologue without hearing the neighbour.

We will then get a chance to gradually do away with problems -- we had quite a lot of them this year -- and gradually correct mistakes made recently.

Anchor: You said during the press conference -- I forget the question -- that as a result of the change of model, the crossroads has been

passed, a certain point has been passed, and we have started moving in a different direction. The prospect of our return to the crossroads, to modifying the model of the state's interference in business, the strengthening of the state's role in business in general -- how far have we gone from the crossroads? Is there a chance to return to elections?

Illarionov: First, we have really gone rather far away from the crossroads. It is not just the distance from the crossroads that matters. The problem is what direction we are moving in: we are moving from the crossroads, we have taken this path. This path means a different model of economic development and social development. It is an interventionist model which spells us nothing good. This is absolutely clear.

On the other hand, no party is destined to make this or that choice. Unfortunately, certain efforts, efforts by society first and foremost, are required to return to the former state. Anyway, we will lose. We are wasting time first and foremost. And naturally this sort of movement costs us quite a lot.

Still, we can return, we can set on a different course of development. But this will require quite a lot of effort.

Anchor: So, we will need this effort. Andrei Illarionov, President Putin's economic adviser was our guest. Let me just remind you that all questions received via the Internet or to our pager will be handed over to Andrei Nikolayevich and he will answer them on his Institute's web site. As for other questions, I don't think this is the last time we meet with Andrei Nikolayevich.

Well, we have not discussed threats.

Illarionov: Perhaps, this will be –

Anchor: It is a hint.

Illarionov: Perhaps this will be the topic of our next meeting here. I would just like to take advantage of this opportunity to wish our listeners Happy New Year. Let next year be better than this year.

Putin's Rule of Law Is Mere Rhetoric

Konstantin Sonin

In a press-conference held on January 23, Andrei Illarionov, the economic advisor of President Putin, said nothing that the journalists present would not have known. He called a fraud a 'fraud', a turning point 'a turning point', and the destruction of professionals 'a destruction of professionals'. However, his press conference quickly became a major sensation because the day before, his patron, President Putin, used the words 'fully legal' and 'completely market' to identify the same events.

Yesterday, 1992-2002

But it is better to start back in 1992, the year of major economic changes in Russia.

For a naive economic theorist, it is the wealthy who benefit from the rule of law. Ideologues of Russian reforms argued that establishing the rule of law, including institutions of property rights protection, requires the creation of a 'grass-roots' demand for the rule of law. In practice, it meant that the former state property should first go into the hands of private owners, and only then would those owners become natural proponents of a system of property rights protection.

This simple model (private owners – demand for the rule of law – property rights) has proven to be a failure. Illustrations abound, and the theory – now being put forward by less naïve economists – is still very simple. The rich – e.g., the beneficiaries of early privatisation – have obvious advantages in protecting their property privately; consequently, they do not have incentives to lobby the establishment of well-working state institutions. They do not need independent courts or efficient bureaucrats. Instead, they seek to increase their political influence and modify the existing state institutions so that resources and wealth continue to be redistributed

in their favour.¹ Even after the summer of 2003, when the pressure on big business in Russia had become intense, businessmen were in no hurry to advocate the protection of property rights for others.

In 2002, a decade after economic reforms were launched, most productive assets were concentrated in the hands of a few individuals, the so-called oligarchs. In part, it is only natural that when property rights are poorly protected, control rights over assets become concentrated. The intuition is that the larger a single owner's share is, the greater their incentives are to pursue improvements, such as improving corporate governance. Recent cross-country studies by a group of economists led by Harvard professor Andrei Shleifer show that the worse the general protection and enforcement of property rights are, the greater the concentration of control rights.

Oligarchs are of course not an exclusively Russian phenomenon and are not an absolute evil. For example, on many occasions, the oil company Yukos was ahead of other large Russian companies in developing new standards of corporate governance and transparency. In 1999, Yukos became the first major Russian company to report by international accounting standards; in 2001, it started to report its quarterly financial statements according to GAAP. The 2002 annual report was audited by PriceWaterhouseCoopers. In August 2001, the *New York Times* reported 'Mr. Khodorkovsky has concentrated on recasting Yukos to look more like a company that investors can trust'.

So, what was so bad about oligarchs, especially since they started to improve corporate governance and cut costs of production? There is no doubt that wealth inequality very often induces heavy costs on the economy, primarily because it produces wide disproportions in the opportunities available to the people. They were also not a natural constituency for the rule of law: this effect is especially strong when economic inequality is accompanied by political inequality.

¹ For a theory, see Sonin, K. (2003) 'Why the Rich May Favor Poor Protection of Property Rights,' *Journal of Comparative Economics*, Vol. 31 (4), 715-731. For an empirical description, see Guriev, S. and Rachinsky, A. (2005) 'The role of oligarchs in Russian capitalism,' *Journal of Economic Perspectives*, forthcoming.

However, the oligarchs' position declined when a group of former security service officers were propelled to the highest offices, including the presidency, by the popular sense of a lack of security, both domestically and internationally. After four years of tough rhetoric and the slow accumulation of power, which were due to the effects of the devaluation of the ruble in 1998 and extraordinary high oil prices coinciding with high growth rates, President Putin and his close circle came to the conclusion that the popular support of any actions against oligarchs might justify action against the strongest of them.

Today, 2003-2004

The events that attracted world-wide attention and started a new page in modern Russian history were the arrests of two major shareholders and founders of the Yukos oil company, Mikhail Khodorkovsky and Platon Lebedev in 2003. Khodorkovsky, the CEO and the largest shareholder of Yukos, was arrested on 25 October 2003 and charged with tax evasion, fraud, forgery, and embezzlement. Before that, Lebedev, a major shareholder and director of Group Menatep, a holding and investment company that owns 61 percent of Yukos (Khodorkovsky is also a major owner of Menatep) was arrested on 2 July 2003, and charged with embezzling state assets in a 1994 privatisation. Subsequently, the prosecutor's office has issued additional charges against Khodorkovsky, a father of four small children, and Lebedev, while their petitions for bail have been repeatedly denied since their arrest.

Now, in January 2005, it might seem that the ultimate destruction of Yukos has always been inevitable. But, in fact, it was not a foregone conclusion. Standard & Poor's, a leading international rating agency, left Yukos' ratings (BB/Stable; ruAA+) unchanged in the days following the jailing of its CEO. The agency's statement which circulated after the Mikhail Khodorkovsky arrest – four months after Platon Lebedev's arrest – said that the positive operational and

financial indices of the company and its high liquidity protect creditors from the negative effects of these developments.²

In November 2003, I wrote an op-ed contribution for the Russian business daily *Vedomosti*, saying that the Yukos affair and the Latin-Americanisation of Russia might not negatively affect the attractiveness of Russian oil for foreign investors. My argument was that world's oil majors have had decades of experience dealing with semi-authoritarian, authoritarian, and outright totalitarian political regimes. And, though political risks are great, the premium in an uncompetitive environment is high. This op-ed caused a small flood of protests from oil company analysts: for them, the jailing of Khodorkovsky was a major holiday. Similarly, the announced merger of Gazprom and Rosneft – widely considered the least efficient companies in the Russian oil and gas sector – caused a lot of enthusiasm in 2004. Of course, Gazprom's acquisition of Rosneft will automatically make the enormous unified company more attractive to investors simply because of its market power. In terms of overall market efficiency – that is, taking into account the merger's impact on consumers as well as companies – this is, of course, a negative.

The fears of a leftist re-distribution, much encouraged in 2003 by the similarities of Mussolini's rise to power in the 1920s in Italy, towards a Brezhnev-like 'stability', have been proven inaccurate in 2004. Two main conclusions can be drawn from the 2004 experience: First, the ideal path for Russia from the standpoint of President Putin and his ideologues is the restoration of the Soviet Union. Though 'physical restoration' is out of sight, the role the government seeks to play is definitely toward the Soviet ideal. Second, people surrounding the Kremlin are no less greedy and self-interested than those that dominated it in the 'roaring 90s'.

Most recent opinion polls show that the year 2004, which has been marred by deadly terrorist attacks that directly affected hundreds, left

² In a short note (Goriaev, A. and Sonin, K. 'Is Political Risk Company Specific? The Market Side of the Yukos Affair', *CEFIR* mimeo), we analyzed the stock market reaction to the arrests. Interestingly, for shares of companies under the state control such as Gazprom, reaction was less pronounced than for private companies.

very grim feelings. A majority of Russians think that the year was a failure for the government; moreover, for the first time in five years more than 50 percent believe that the country is heading in the wrong direction. The end of 2004 was marked by two major events related to the impact of the rule of law.

The first was the final destruction of Yukos, with the sale of Yuganskenftegaz, its main production unit.³ The sale came after the company has been charged with tax claims for 2000-2003 that exceeded its gross revenue. The sale itself was a live reminder of the 'loans-for-shares' scheme, a series of privatisation auctions, for which the oligarchs have been blamed ever since. A shield company with unknown owners, registered in a single-room office in a provincial town of Tver, successfully amassed (from unknown sources) some \$9 billion to pay for the company with a market and expert valuation at about \$18 billion. The decision by a Houston court that stopped a consortium of Western banks from financing the purchase of the Yugansk by Gazprom, though indeed controversial, may have saved substantial reputations and money for the members of the consortium.

The second event was a change in the design of the Russian administrative system which replaced the elected governors of Russian regions by appointed ones. According to experts, the new laws violate a number of provisions in the Constitution, the very concept of federalism enshrined in our country's official name: the Russian Federation, as well as Constitutional Court rulings that – according to the Constitution – are not subject to review. With respect to other direct elections, in nearly half of Russia's 89 regions, one-third of the population lives in the region's largest city. Now, appointed – and therefore less legitimate and less influential – governors will have to compete with the elected mayors of big cities. Scrapping mayoral elections is therefore the obvious next step in the process. With a bit of exaggeration, inductive reasoning suggests

³ Yukos is an acronym of the names of two state-owned companies that were merged and subsequently privatized by the Russian government: Yuganskneftegaz and KuybyshevOrgSintez.

that all remaining direct elections will be gradually phased out as well.

Both of these events imply that the rule of law – a much talked about theme of the first four years of the Putin administration – is mere rhetoric. This also clarifies the way the Kremlin plans to deal with the existing laws: whether it is the Constitution or a criminal law: it will be violated without change, and officials will claim that they act according to the law. In a number of televised appearances, President Putin called the whole operation ‘completely legal’. Strictly adhering to this ‘legal positivism’, Sergei Ivanov, the Defence Minister and a possible heir should Putin, as required by the Constitution, step down in 2008, said in New York on 13 January 2005 that the Yugansk auction, held on 19 December 2004, was in full accordance with Russian law and the subsequent series of murky transactions was ‘fully [according to the] market’.

Tomorrow, 2005

In the economic sphere, Russia will witness more active interference by the government, formally aimed at ridding the country of its dependence on resource exports, which will predictably produce structural flaws. The record of the developing world has proven the inefficiency of state-managed investment in countries rich in natural resources. For instance, in Nigeria, physical capital grew at a rate of over 6 percent a year between 1965 and 1998, while per capita GDP increased by around one percent. The physical capital swelled mostly due to government investment. In the past 30 years, the OPEC member states have seen a decline of their per capita GDP at an average rate of 1.3 percent a year.

Toward the Soviet ideal, the government will continue pursuing an economic policy intended primarily to prolong and even develop the environment in which monsters like Gazprom thrive. The promised reforms of Gazprom, RAO UES, and the Russian Railroads will stall. Those who wait for liberalisation of Gazprom shares will have to wait a few more years. It would not be surprising if reports – or at least rumours – surface soon about upcoming mega-mergers in the ferrous metals sector. Despite the liberal rhetoric of some Cabinet members, the president seems to sincerely believe that restoring the

discredited Soviet system of economic management is the best thing for the Russian economy today.

One thing to watch is the new media law, which is being prepared in total secrecy, but occasional leaks suggest that it might be as devastating for print media as Putin's accession was to the electronic media. Without the media, any investor smaller than BP or Deutsche Bank would be at risk. Another concern is the reappointment process for governors. Companies that invest in Russian regions might find it more difficult to get credible commitments from appointed governors, even in comparison with the notoriously corrupt elected governors of yesterday. The appointment of a top Yeltsin bureaucrat, such as Kasyanov or Stepashin, as the Prime Minister might be a good sign – at least this would be an insurance against a catastrophic development.

In August 2003, after the first arrest of a Yukos executive – which in hindsight seems to be a turning point in the history of modern Russia – I wrote, in an op-ed contribution to the *Moscow Times*:

Privatisation and the subsequent events of the 1990s have resulted in a dramatically uneven distribution of wealth in Russia. There is little doubt that it has had and continues to have a negative effect on economic development. However, a new round of forced redistribution will not improve the situation. Rather, Russia could be drawn into an endless cycle of property redistribution from rich to poor and vice versa.

A year and half later, I still think so.

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The political changes in Russia in recent years, particularly the rise in assassination of journalists and the concentration of media ownership, alongside the weakening of the multi-party system and strengthening of individual rule by the President, represent a fundamental break from any model of liberal democracy and its values. History teaches us that such breaks, if anything more than temporary, are in and of themselves a fundamental threat to the survival of a democratic system in the country concerned.

Whatever the motivations, the curbs on press freedom and the weakening of the multi-party system cannot be allowed to stand. Russia is a 'weak authoritarian state with nuclear weapons'. The Putin Administration must move quickly to enforce rule of law and protect individual civil rights. The UK should apply whatever leverage it possesses (including through multilateral economic co-operation agreements) to vigorously promote the protection of the hard-won rights and freedoms in Russia.

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state is like hundreds of actors with too wide a variety of motives and too low a visibility for them to be easily deterred. On the other hand, rogue states- which have singular and effective governments- might be deterred.

'His report demands a major overhaul of world rules on nuclear technology'.

BBC Online

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Joshua Cooper Ramo

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The former Foreign Editor of Time magazine, Joshua Ramo, argues that there is a new 'Beijing Consensus' emerging with distinct attitudes to politics, development and the global balance of power. It is driven, the author argues, by a ruthless willingness to innovate, a strong belief in sovereignty and multilateralism, and a desire to accumulate the tools of 'asymmetric power projection'. Though it is often misunderstood as a nascent superpower, China has no intention of entering an arms race. Instead, it is intent on projecting enough 'asymmetric power' to limit US political and military action in its region. Through fostering good international relations, it is safeguarding the peaceful environment needed to secure its prosperity, and deterring the attempts of some on the fringes of US politics to turn it into a pariah. Ramo argues that China offers hope to developing countries after the collapse of the Washington consensus. It provides a more equitable paradigm of development that countries from Malaysia to Korea are following. Based on more than a hundred off the record discussions, *The Beijing Consensus* captures the excitement of a country where change, newness and innovation are rebounding around journal articles, dinner conversations and policy-debates with mantra-like regularity.

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By Mark Leonard and Phoebe Griffith

October 2003; available free online

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