

Russia's economic failures and geopolitical risks

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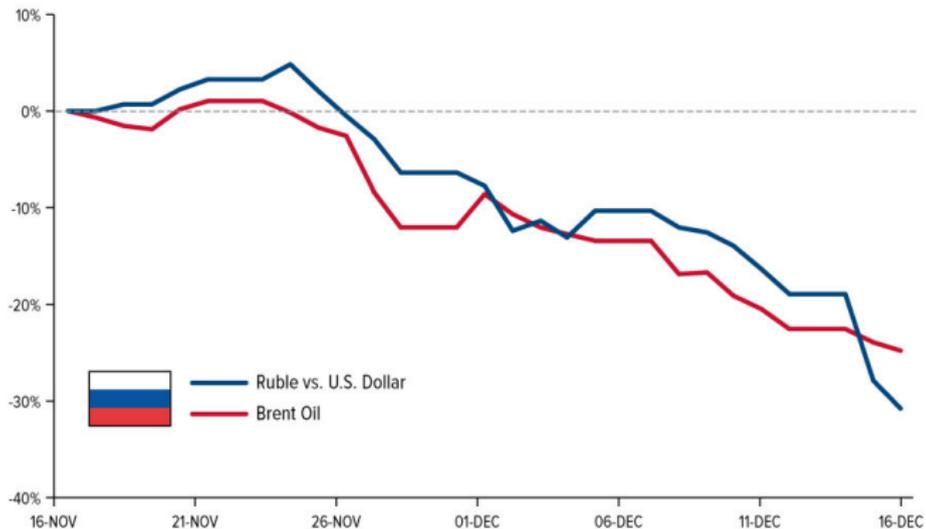
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Overview

- ▶ Current events resemble past events
- ▶ A sketch of Russia's economic history
- ▶ Some theory on Russia's economic weakness
- ▶ Lower oil prices: opportunity or threat?

Russian Currency's Tumble Tied to Falling Brent Oil Prices



Past performance does not guarantee future results.

Source: Bloomberg, U.S. Global Investors

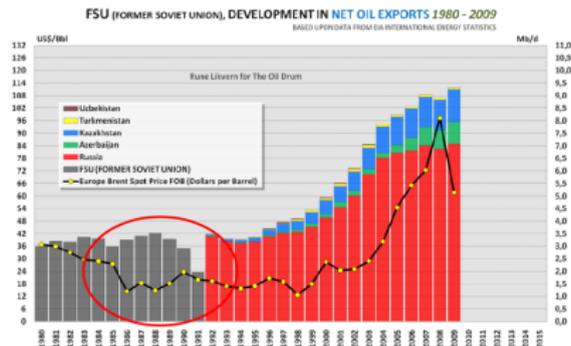
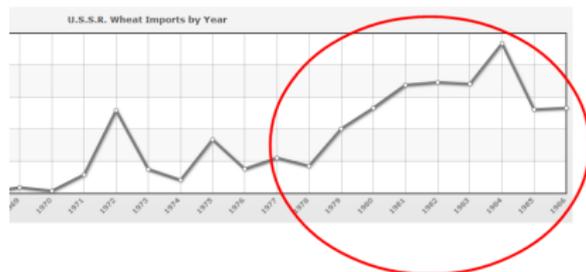
“War is the continuation of politics by other means”



NB: Russian wars distract from economic failures; American wars are based on naïveté.

Food insecurity in the 1980s

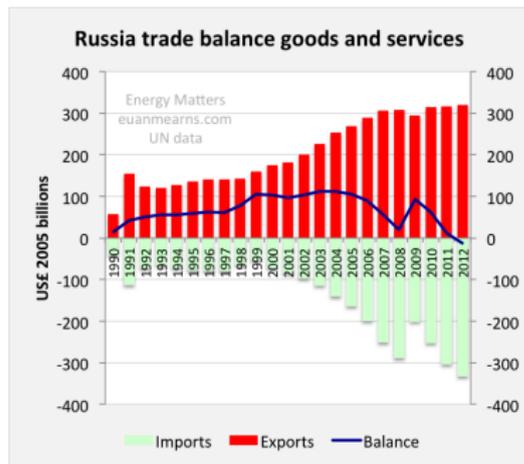
Imports can replace failed production *if* there's enough money



NB: "Bread rioters" propelled the French revolution, Russian Revolt of Feb 1917, Arab Spring, etc.

Middle class insecurity now

Putin has taken credit for improved living standards bought with oil revenues (not improved productivity).



This model — and the accompanying quid-pro-quo (“You can eat so be quiet”) — is now destabilized.

An overgeneralized economic history

Pre-1861 Feudal economy failing; debt increasing

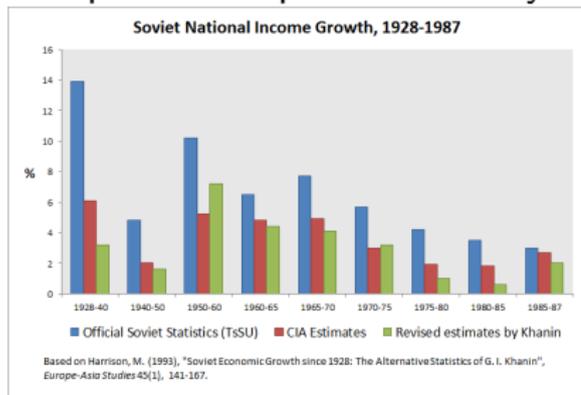
1861-6 Serfs freed (84% vs 14% slaves in US)

Pre-1917 Poor population (and bureaucrats) depend on foreign-led industrialization of agricultural economy

Communism “Soviet power + electrification” [+ brutality]

Post-WWII A-bomb, Sputnik, etc., but no competitive exports

1980s “Surprise” collapse of economy



1990s “Spontaneous” (corrupt, KGB-led) privatization

2000+ Tsar Putin rules with oil and brutality

Why is Russia's economy weak?

Russia has not escaped its past. . .

- ▶ Economic power flows from political power
- ▶ Economic decisions are not market-tested
- ▶ Economic production depends on resources
- ▶ Economic activity is channelled through the State

Bottom Line: The Russian economy depends on oil. High oil prices bring power and stability. Low oil prices expose weaknesses. Weakness is compensated by violence.¹

¹Violence in times of strength is used against those who call attention to corruption and theft.

Two models of political economy

North, Wallis and Weingast set out two models:

The *Open Access State* administers laws impersonally, such that anyone can operate a business or run for public office.

The *Natural State* favors an inside group to the point where power is necessary to run a business and money gives one access to power.

Russia is a Natural State, e.g., Yukos (Khodorkovsky imprisoned; assets given to Rosneft and Gazprom) or Sochi Olympics (\$50 billion cost due to no bid contracts).

Two models of capitalism

In a *competitive* system, profit-seeking entrepreneurs battle in a market subject to Schumpeter's "gales of creative destruction." Firms come and go but overall productivity improves. The State administers clear regulations and provides non-market goods such as welfare.

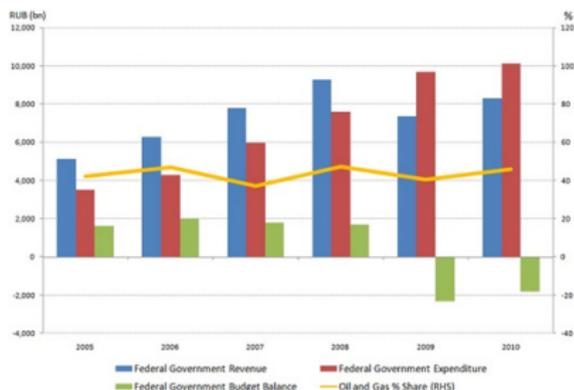
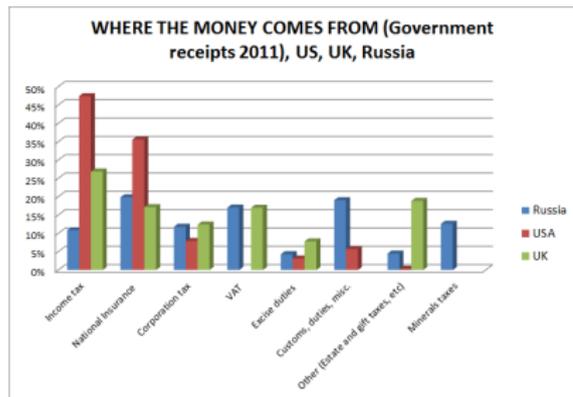
In a *crony* system, insiders enjoy monopolistic profits and the State manages the "commanding heights" of the economy (e.g., oil, telecoms, steel, transport). Managers are protected from failure. Citizens survive on minimal handouts.

F.A. Hayek (1945) warned that crony systems would fail due to the difficulty in "managing" the transfer of productive resources to consumptive desires. (Corruption is another serious problem.)

Two models of government funding

Government depends on *taxes*. Citizens get services.

Government depends on *resource rents*. Ignores citizens.



Russia's government gets 46 percent of its revenue from oil/gas.

Two models of risk

Minimize risk through diversification, i.e., jobs and revenues come from different industries, locations, technologies, etc.

Maximize risk through concentration, i.e., jobs and revenues come from few people or industries.

The Russian government directly controls 50 percent of energy and banking, 70 percent of transport. It indirectly controls media and large businesses (e.g., arms, aerospace, minerals, wood).

Current events are hammering Russia's economy

- ▶ Russia is under sanctions for invading Ukraine
- ▶ OPEC has allowed the oil price to drop
- ▶ The ruble is falling as Russians buy hard currencies
- ▶ Big external debts coming due

Putin et al. say “nema problema” due to large USD reserves, but

- ▶ Food imports have been reduced “to punish” the EU
- ▶ Ruble still falls after interest rates increased from 10% to 17%
- ▶ Sales of Ikea kitchens (and other capital goods) are up!
- ▶ China is getting some good energy deals
- ▶ More critics (e.g., Navalny and Nemtsov) in jail
- ▶ Government limits vodka price increases (!)

Interesting! Government ruble revenues have *risen* as the currency has fallen faster than the oil price. Nominal payments (e.g., pensions) may not fall, but buying power is way down.

If rich Russia invades, then what will poor Russia do?

Invasions distract citizens from mismanagement and theft, but Putin is still very popular.

State-controlled media blames “foreigners.”

The rich are moving money and assets abroad.

The poor are facing higher prices and cuts in government services.

Putin can distract attention by:

- ▶ Cutting energy exports or raising prices (“breach of contract”)
- ▶ Invading Transdnestria or the Baltics
- ▶ Seizing more assets within Russia
- ▶ Making a deal with Germany, bypassing Poland

What should the West do?

- ▶ End sanctions against “Russians”
- ▶ Enforce transparency and competition regulations
- ▶ Increase military presence in Baltics and Poland
- ▶ Trade with Ukraine et al.
- ▶ Increase educational exchanges with Russia et al.

Leave Russia to destroy itself.

Questions?



"To make it look like an accident."

Get this presentation (and links on next page) at
http://www.kysq.org/docs/2015.01.07_Russia.pdf

Additional reading

<http://www.washingtonpost.com/blogs/wonkblog/wp/2014/12/15/russias-economy-is-doomed-its-that-simple/>
<http://www.nybooks.com/articles/archives/2014/dec/18/how-he-and-his-cronies-stole-russia/>
<http://www.newrepublic.com/article/120503/what-moscow-was-after-dissolution-ussr-1992>
<http://www.reuters.com/investigates/section/comrade-capitalism/>
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