

Putin Underestimated: The Russian Economy isn't Doomed

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Introductory Remarks



Outline

- What is the dispute?
- Trade sanctions have never worked and will not solve this
- Oil prices: Great...but it will take too long
- External debts: Slow running problem, but not insurmountable



What is the dispute?

- Ukraine has centuries-long history of Russian domination
- Russia has a large military interest controlling the Black Sea through Crimea
- Ukraine has been quite weak and economically dependent on Russia since 1991; loss to Russian sphere of influence
- Part of a bigger shift in Russia political relations in the post-USSR world



What is the dispute?

- Putin also asserts a right to protect Russian speakers in other countries: Economic cloud over Eastern Europe
- Eurasian Economic Union (EEU) set up to economically and politically dominate former USSR states
- Seems increasingly aggressive, using tactics of former Soviet Union
 - Use of salami tactics in Ukraine
 - Military activity in Europe: particularly Baltic countries



EEU: Make a bigger political and economic power





Sanctions Introduced

- Sanctions will not work in the Russian case
- Economic sanctions – the withdrawal (or the threat) of customary trade or financial relations
- Viewed as a liberal alternative to war: believed to be as effective as military force and more humane
- Military instruments thought to be an effective means for achieving ambitious goals (e.g. territorial changes or changing a regime), but costs are high
- They are therefore frequently used when the issuing country/countries (initially) do not want to commit military force.



Sanctions Introduced

- Trade restrictions are:
 - Used to persuade target to change through cost-benefit analysis
 - Lowers aggregate welfare of international state by reducing international trade [Russian case: yes, importer: access to goods]
 - Costly substitute goods, produced by target, divert resources from other areas (target economy as a whole) [Russia: yes]
 - Also used to ferment rebellion by citizens [Russia: NO!]
 - Partial sanctions as a signal for more to come; investment withdrawal [Russia: possible]



Sanctions as a Political Tool

Are sanctions an effective tool for achieving international political goals? Do conditions matter?

Key characteristics of sanctions before and after 1990

	1946–1989		After 1990	
	yes	no	yes	no
Ongoing sanctions				
Annual average number of sanctions	2.6	2.3	4.5	3.8
Share of successes	32%	34%	39%	40%
Trade linkage				
Share of target's trade	22%	23%	45%	45%
Percentage of target's GDP	6%	6%	11%	10%
Period (years)	8.9	7.8	4.2	4.1

Sources: Number of sanctions, success rate, and period calculated from Hufbauer *et al* (2008). Trade linkage based on many economic sources for trade and GDP as detailed in Van Bergeijk (2009, Appendix 6.A1, pp 138–46)



Sanctions as a Political Tool

- 40% success on the surface, but conditions matter. Let's boil that down a bit:
- Hufbauer et al initial study – 79 failures; 40 claimed successes, but most later discredited by Pape and others
 - 18 settled by use of force (suggests force + sanctions work)
 - 8 cases no evidence of change
 - 6 were not economic, but rather targeted individual sanctions
 - **5 successes, all very trivial**
- **Suggests about a 6% success rate**



Sanctions as a Political Tool

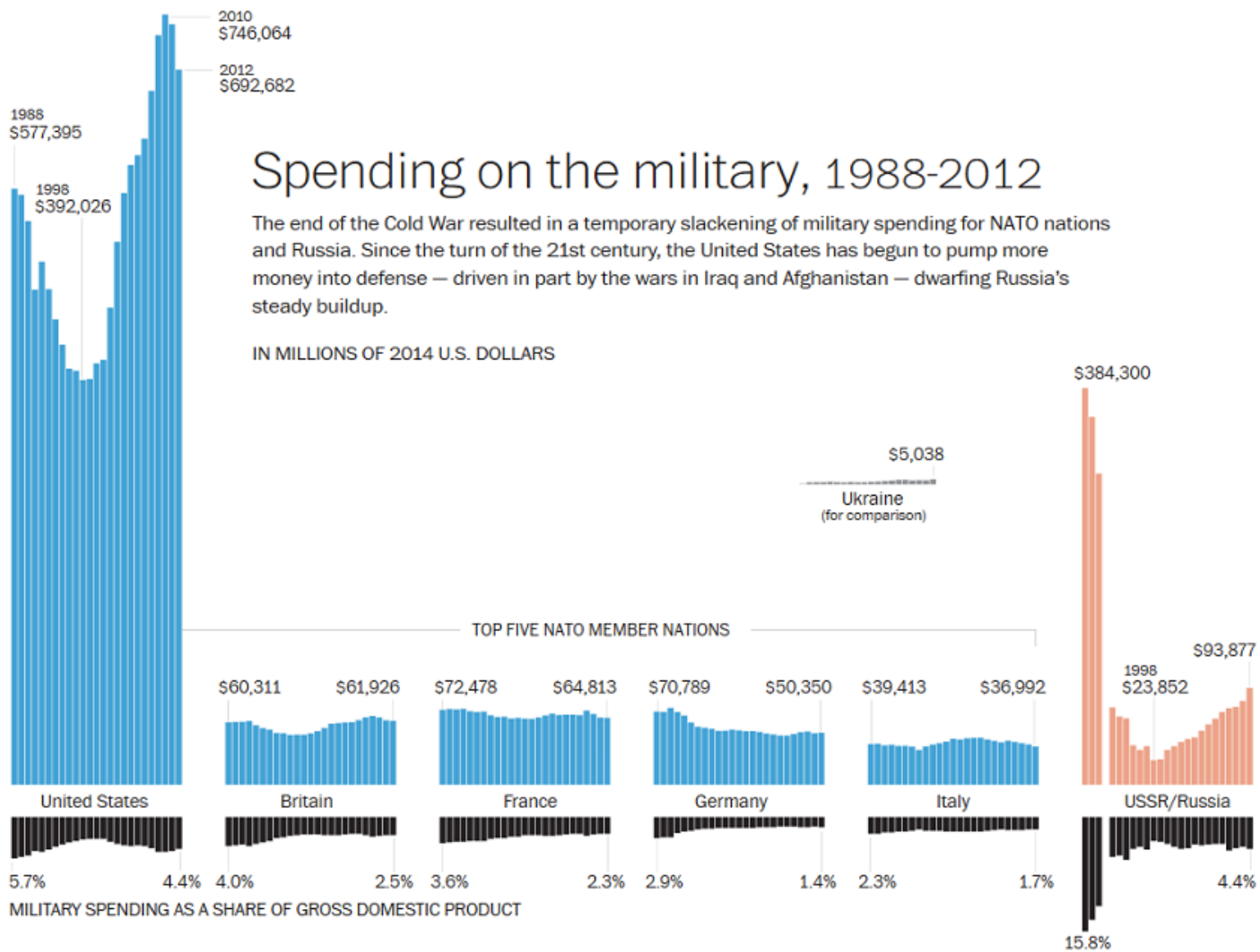
- 5 successes were pretty trivial:
- UK-USSR (1933): Soviet Union agrees to release 6 British nationals accused of spying
- US/Canada-South Korea (1975): Sanctions for human rights abuses by an ally; SK stops building nuclear weapons
- Arab League-Canada (1979): Canada agreed not to move its Embassy from Tel Aviv to Jerusalem
- US-El Salvador (1987): El Salvador agreed not to release 3 prisoners
- India-Nepal (1989): Nepal agrees not to buy weapons from China



Sanctions as a Political Tool

- Are sanctions an effective substitute for war?
- They are not a reliable alternative to military force
- M = cost from military force, S = cost from sanctions
- Typical situation: $M > S$, military force bigger threat.
- Possible back down situation: $M < S$, sanctions costlier
- Regime also has to be under threat from sanctions.
 - $M < S$ was true in Iraq, Libya, Russia, Palestine (occupied), Syria, etc; but regime stays stable, people suffer.
- Only situations where $M < S$ AND where the ruling elite or regime itself is threatened, do we see any results from sanctions. Only situation where this is possible is WAR.

Military: if Russia fully engages Ukraine can't win



SOURCE: Stockholm International Peace Research Institute.

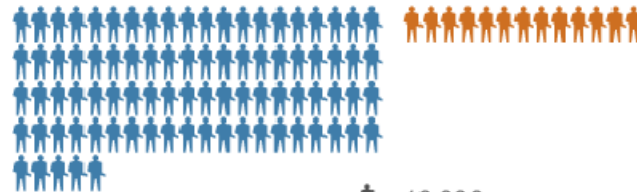
Military: if Russia fully engages Ukraine can't win

Military balance: Russia and Ukraine

Russia

Ukraine

Armed forces



1 icon = 10,000

845,000 **129,950**

Tanks



1 icon = 100

2,500 **1,110**

Combat aircraft



1 icon = 100

1,389 **221**

Combat vessels



1 icon = 10

Black Sea fleet: 25 **171** **17**

Source: IISS



Sanctions as a Political Tool

- If Russia commits to war, Ukraine militarily can't win without NATO assistance. So we revert to sanctions; can they win in this case?
- EU estimated loss of trade to Russia: \$25bn-\$85bn (1.5-4.8% GDP)
- Substituted cost: \$35-\$100bn
- Net cost of sanctions (based on Iraq 1994-98 premium): \$10-15bn (0.6-0.9% GDP)
- Substitution mechanism: Belarus, Armenia, China
- -> Trade sanctions have a bad history and costs are too small; we cannot win with trade sanctions alone.



Sanctions as a Political Tool

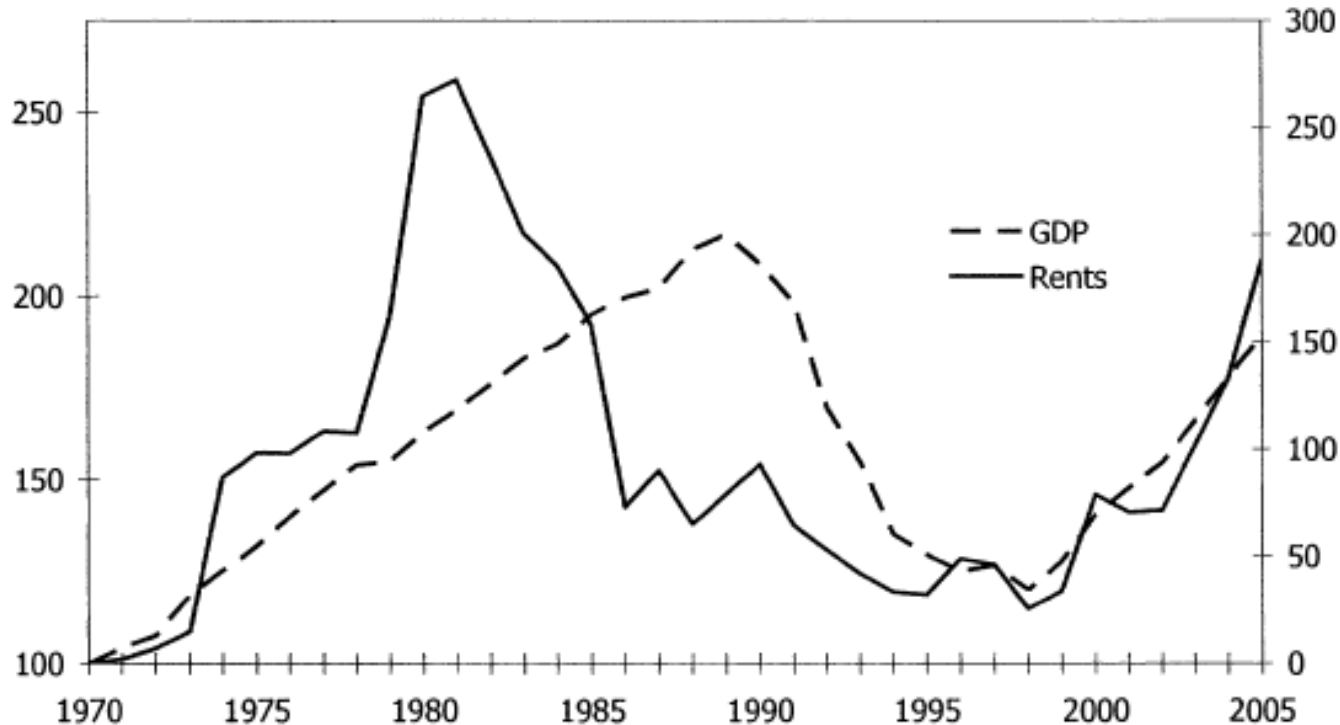
- Only situations where $M < S$ AND where the ruling elite or regime itself is threatened, do we see any results from sanctions.
- Sanctions success can not met:
- $M < S$ Ukraine can not win militarily if Russia fully engages; and
- Putin is not threatened by revolution (strong internal police state)
- Already the Europeans are feeling the pain of their \$60bn of sanctions. French proposing to remove EU sanctions (BBC, 05 Jan); they expire July 2015.
- **Suggests sanctions ineffective; minimal costs of \$10-15bn to Russian economy; Russia wins within 9-18 months.**

Oil: odd parallel to the USSR

- Why did the Soviet Union collapse?

*Russia's GDP
(1970 = 100)*

*Oil and gas rents,
2005 USD blns*

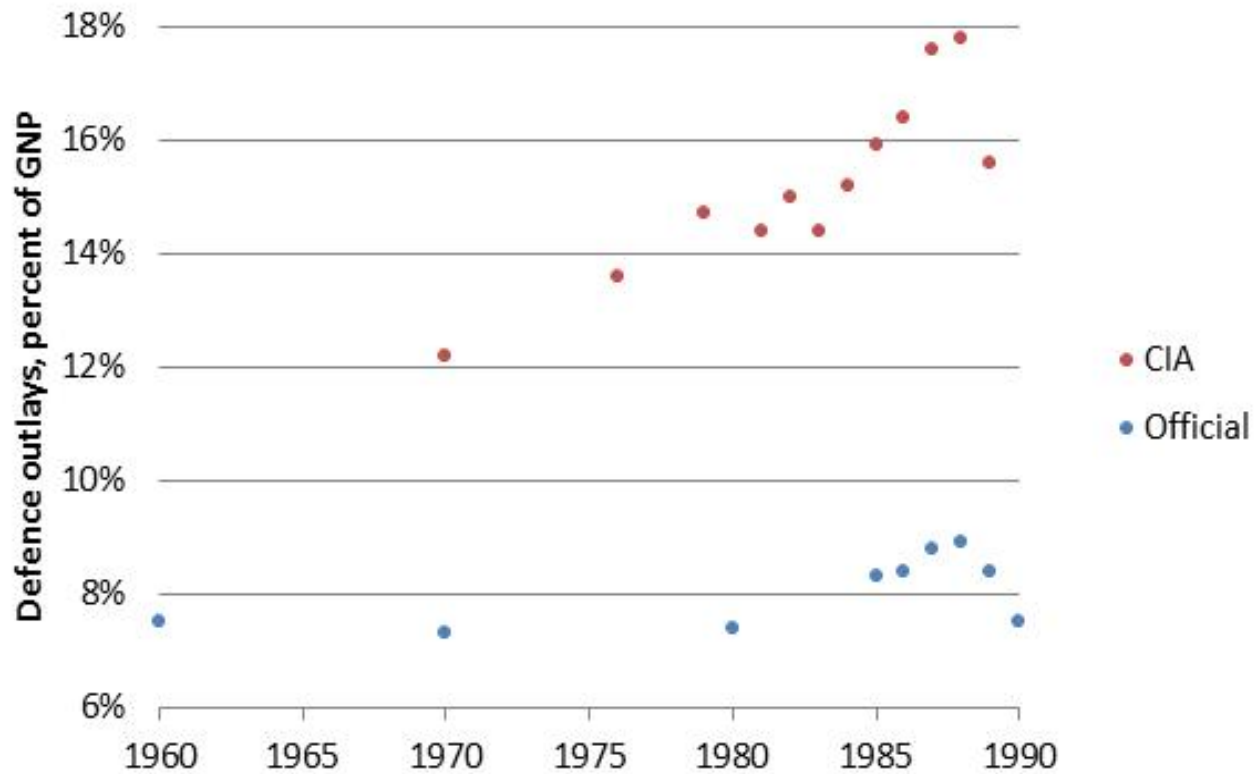


- The command system: secrecy and overcentralization.
- Withdrawal of oil rents (Gaddy and Ickes 2005).
- Failure of credible threats: the Gorbachev factor (Harrison 2002).

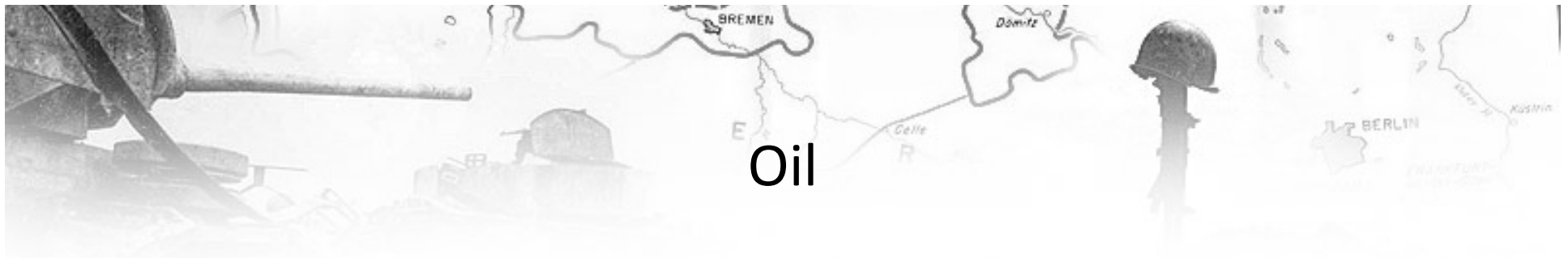


Oil and the USSR

- Evidence on the Soviet military burden:

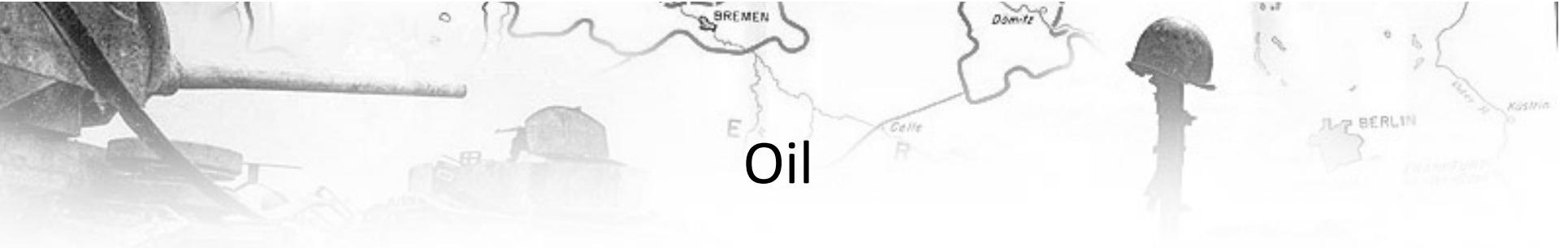


Source: CIA: Firth and Noren (1998: pp. 129-130). “Official” Soviet defence outlays are provided not contemporaneously but retrospectively on 1989 basis by Masliukov and Glubokov (1999, p. 105).

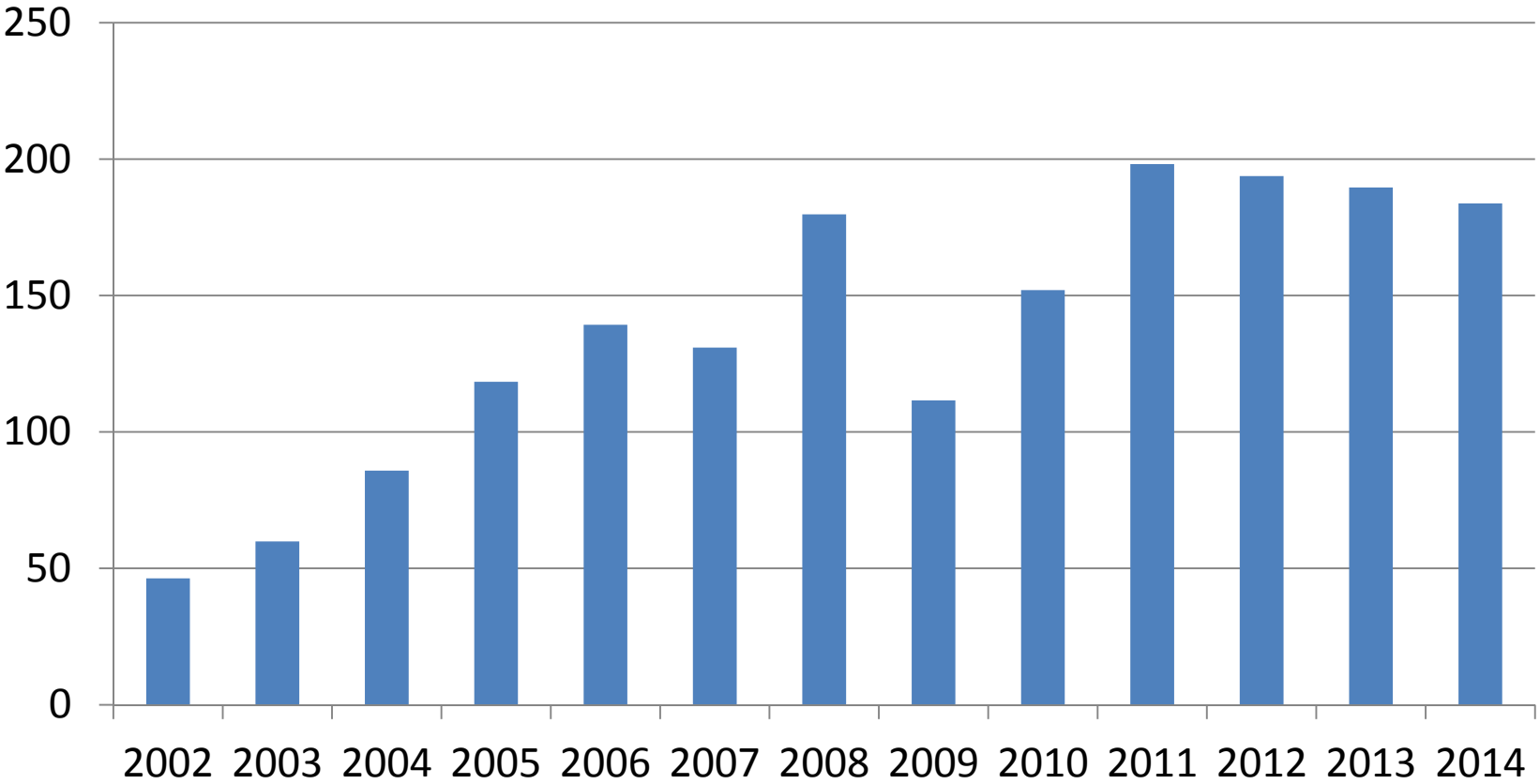


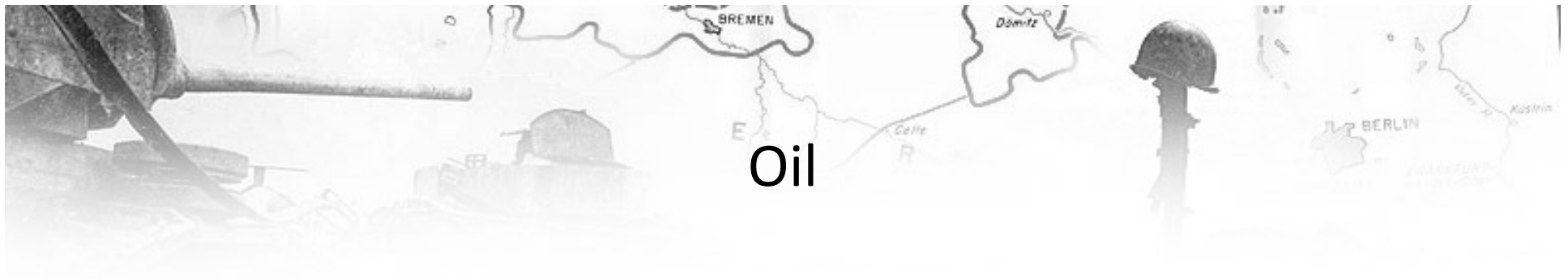
Oil

- Certainly an oil factor is present now
- OPECs oil policies hurt Russia, more than the sanctions
- Oil moves from \$110 -> \$47
- At \$2bn per dollar fall, that's a net loss of \$126bn in export earnings (7.2% of GDP!) at current production levels
- But that does not place Russia into a trade deficit, still generating a c. \$60bn surplus per year

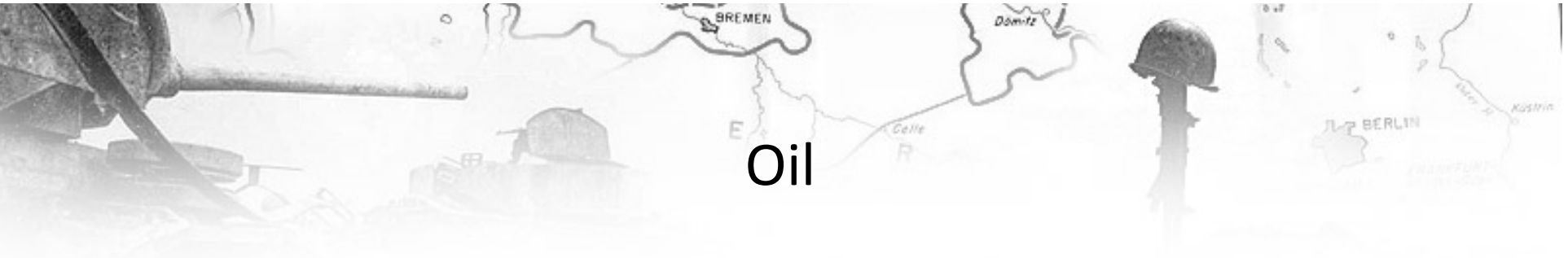


Russian Balance of Trade (USD Billion)

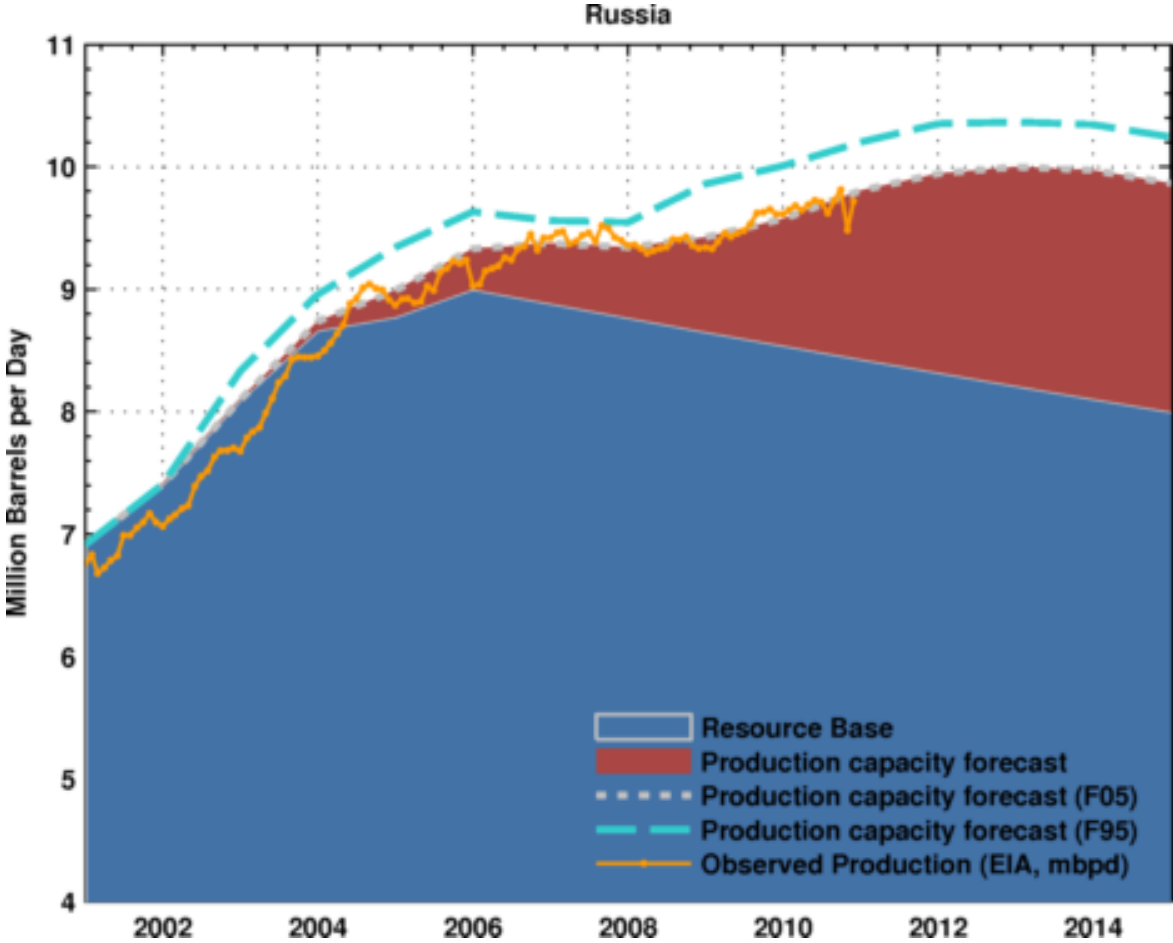


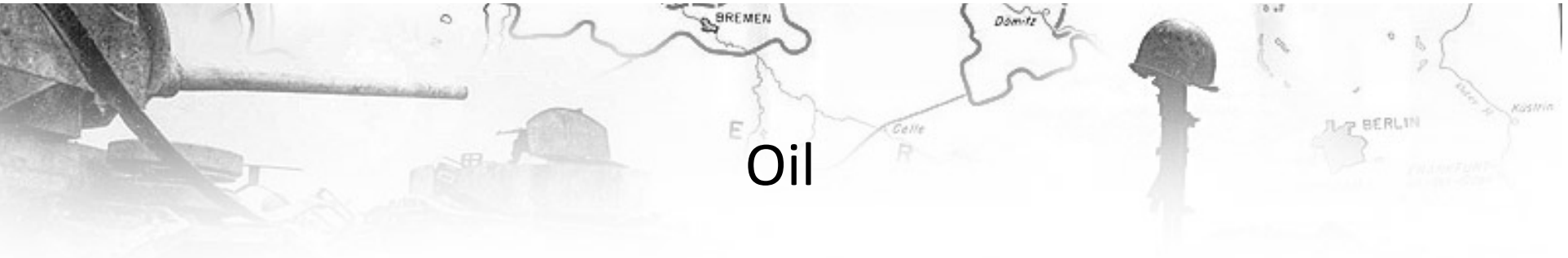


- There will be economic contraction of approx. 3-5% GDP due to oil price decline; of up to 5% with other factors.
- Additional pumping could minimize the decline through increased production. Russians have been increasing production steadily now since 2002 and some reserve capacity c. 10% or \$24bn pa production available.
- Could start pumping more natural gas, which China eagerly wants



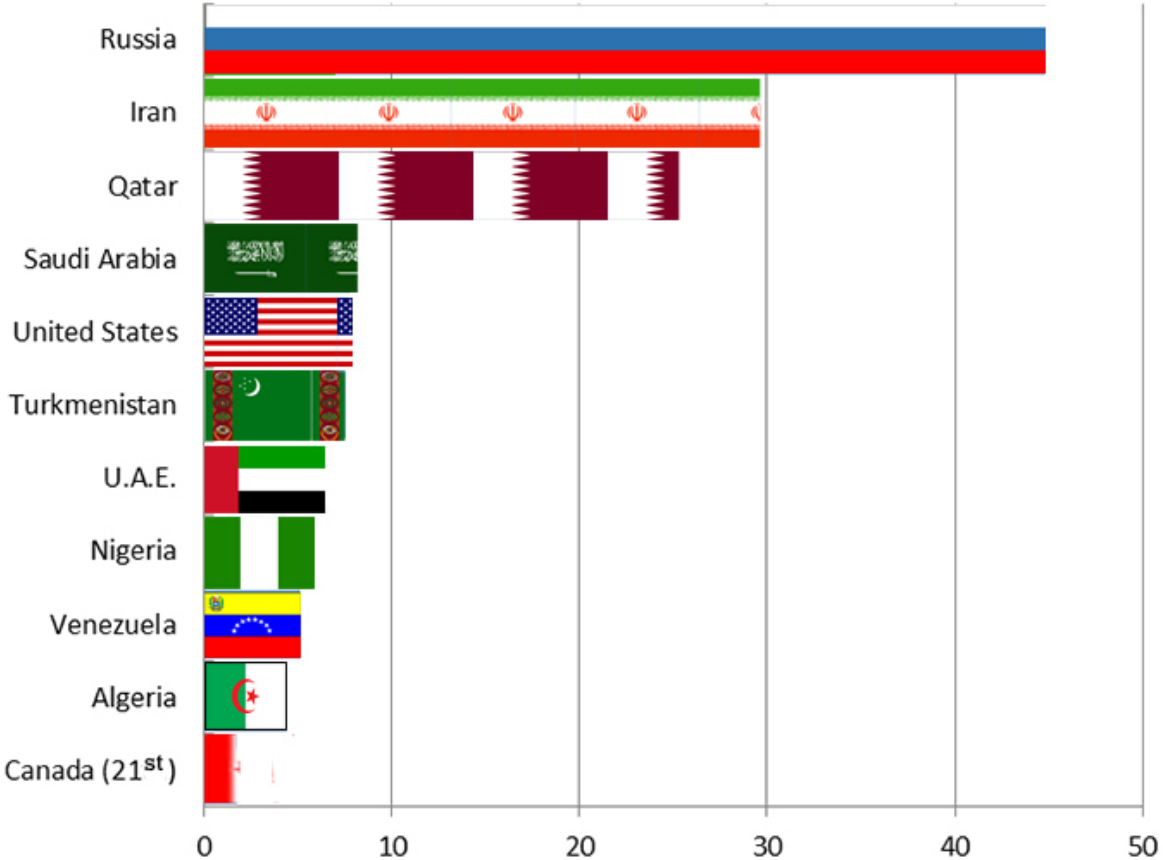
- Could further capacity be found? Certainly





- Natural gas capacity certain can: and China wants it.

World's Largest Conventional Natural Gas Reserves (Trillion Cubic Metres)

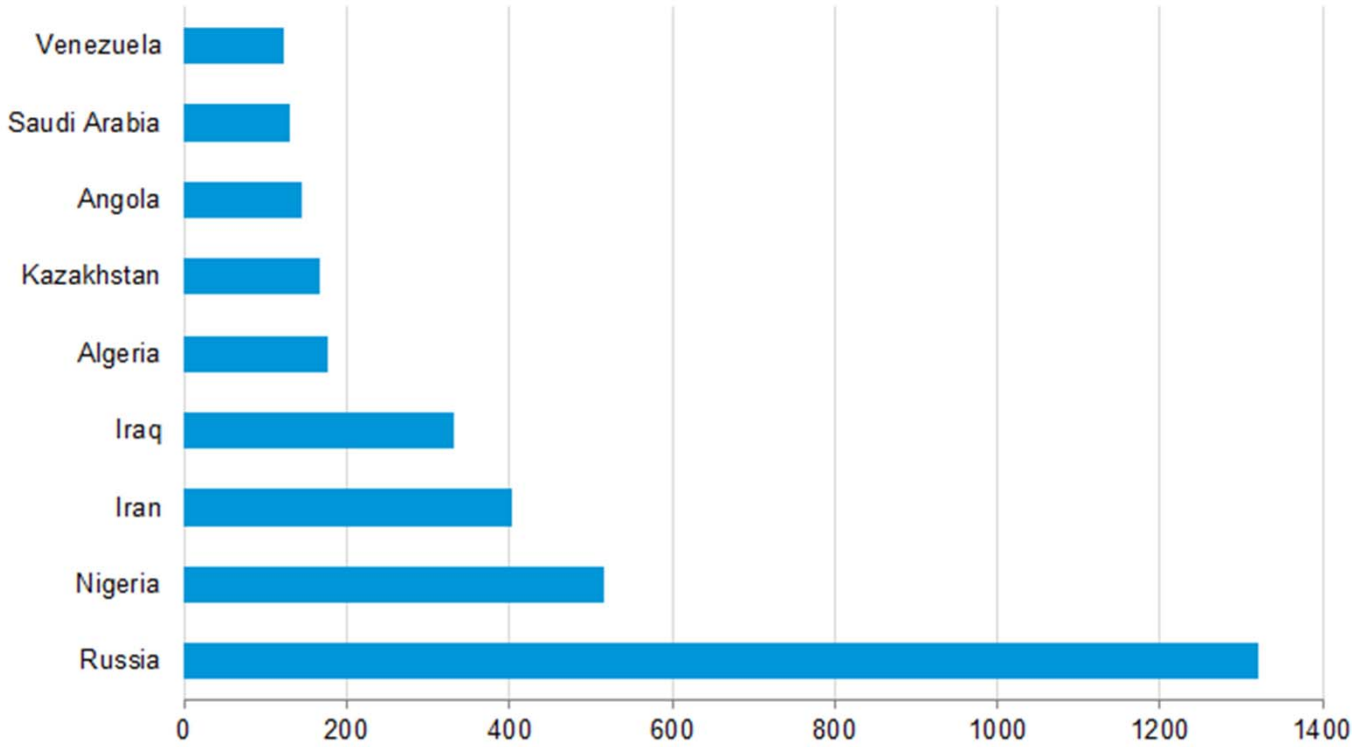




- Natural gas capacity certain can: No development costs either. Roughly \$5bn currently just being wasted!

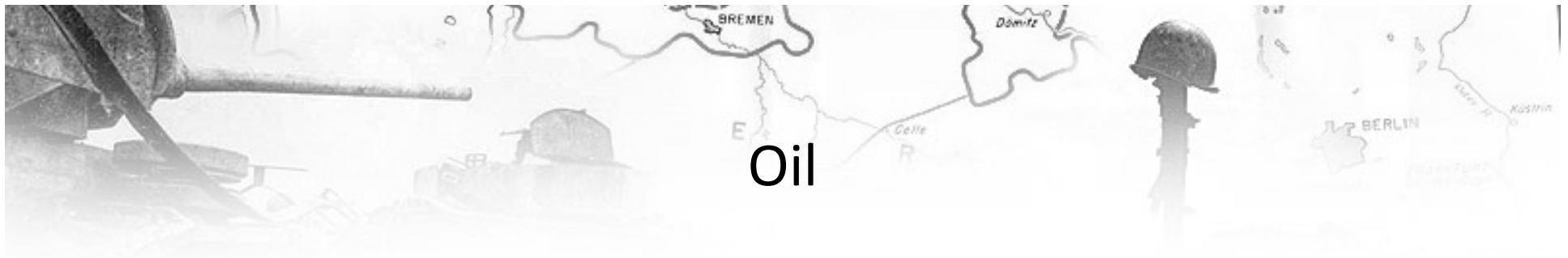
Largest source countries of flared natural gas, 2011

billion cubic feet



Source: National Oceanic and Atmospheric Administration





- However, regime collapse will not occur. Other conditions present during collapse of USSR are not present here:
 - Putin is a dictator; not a Gorbachev
 - Failure of credible threats: the Gorbachev factor
 - Not a command economy; although theft by oligarchs does occur
 - The command system: secrecy and over-centralization
 - High levels of military spending not present (currently 4.4%)
 - Withdrawal of oil rents
- -> Does not suggest economic or military collapse. Suggests oil price decline will cause a severe 5% GDP recession and reduce trade income at most.



Capital Flows

- Uncertainty and targeted sanctions against banking industry are problematic
- Removal of major Russia banks from the international SWIFT banking and Visa-Mastercard payments systems; inability to renew international finance agreements
- Loss of capital reached c. \$40bn per month at end of 2014, reaching nearly \$130bn for the full year
- However, it appears c.\$50bn represents payments on external debts to July. Estimate further \$55bn July to December 2014



Capital Flows

RUSSIA EXTERNAL DEBT

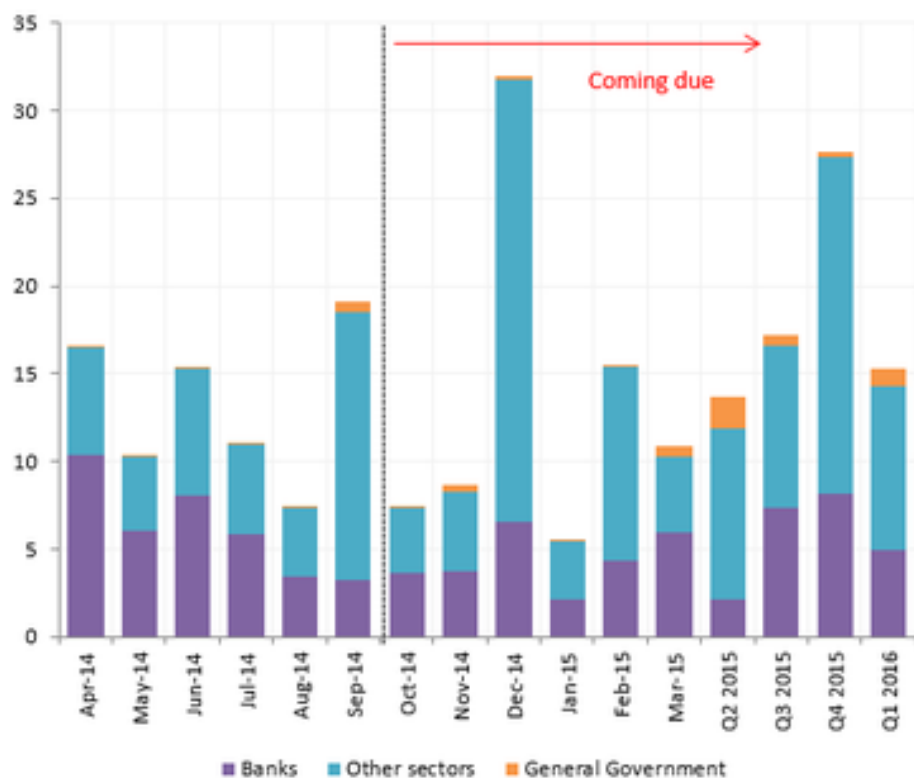


SOURCE: WWW.TRADINGECONOMICS.COM | CENTRAL BANK OF RUSSIA

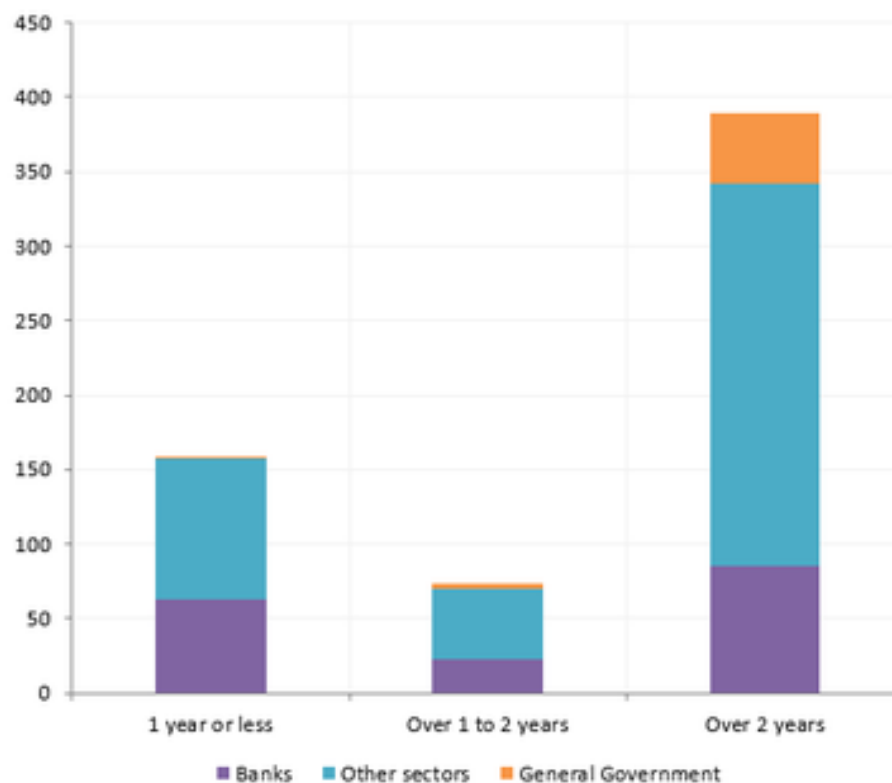


Capital Flows

Redemptions - Russia external debt < 2ys (USD bn)



Redemptions - Russia external debt - summary (USD bn)





Capital Flows

- Russia has reserves of \$385.5bn as of 31/12/2014, down from \$509.5bn in 31/12/2013. Loss of \$124bn
- If we assume \$105bn to repay external debts, this is a net capital outflow of \$24bn. Again not large.
- So issue is payment of external debt. In the next 2 years, total of \$225bn coming due. Slow running train wreck, but hardly a concern with an annual trade surplus of c. \$60bn at current oil prices and reserves of \$385bn.



Capital Flows

- Even if you did consider it a problem, \$100bn (5.5% of GDP) in unfunded external payments could easily be funded with:
- Externally: Chinese capital, paid in \$ for oil projects
- If concerned about effects on domestic money:
- Internally: Cheap domestic capital created by Russian Central Bank (depreciation in the Rouble will occur, but economic pain lessened)
- -> Slow running problem, not a crisis, which can be solved. Looks a lot like the US (which had a 4.8% deficit in 2013).



Conclusions

- Russia will no longer be a BRICS country, growth will be negative, possibly up to 5% of GDP in 2014-2015
- But the Russian economy is not going to spiral out of control at this stage; it has none of the signals of an economy in collapse.
 - No big sanctions crisis (\$10-15bn cost)
 - Oil price – reduction in trade earnings, but still in surplus
 - Capital flows is a slow problem, not a fast one.
- Putin's position is strong
- More international concern should be placed on the Ukrainian economy and Eastern European defense generally