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DESK NOTE

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Through Western Eyes: *T&B*'s Eric Kraus on Russia's Channel One TV

T&B recently participated in a series of broadcasts on the global economy and its influence on Russia for Russia's Channel One. We requested a list of questions to help prepare for the filming, and, after the show, decided that they would make a useful stand-alone, summarizing our current views quite neatly, while we struggle to finalize our next full report…

Channel One: The president of the World Bank has just warned that the world is "*one shock away from a (new) full-blown crisis*". Does the crisis have to be "*global*" – can Russia avoid it?

Eric Kraus: The amazing thing is that we have seen, in rapid-fire succession, a political meltdown in the Middle East, the world's second largest economy being hit by a ten-metre wall of water, crude oil prices soaring out of control, a tanking US dollar, a major debt crisis in Europe with a far more dangerous one brewing in the US causing S&P to downgrade the US credit outlook – and yet the markets continue to sail along, oblivious to it all. *THAT* is the weird thing. What will it take for it to unwind? For how long can the continued provision of liquidity by central banks and deficit-governments continue to delay the day of reckoning?

Crises are discontinuities. During crises, reality flows much faster. Theories are tested – sometimes with strikingly unexpected results. While it is relatively easy to predict that "*at some point there will be a crisis*", that prediction – alone – is fairly useless… Timing the inevitable is a major challenge, and it is even more difficult to predict what the crisis will actually look like once it gets underway. It will reliably surprise you. It is like peering into a black hole.

Assets one would have expected to hold their value collapse, while those expected to suffer the greatest damage can do very well, at least early on in the crisis.

The short-, medium- and long-term effects of crises tend to be highly divergent. A currency or asset class can initially surge on technical grounds, before turning around and crashing due to its dire fundamentals. The US dollar surged during the American subprime crisis as European banks scrambled to find dollars to cover the huge losses in US credit markets. That strength has now been reversed as the debasing of the currency becomes increasingly obvious.

As regards the Russian markets, since they are largely integrated into the global financial trading system, any major sell-off will hit Moscow too. After the first whiff of panic, the question becomes, what are the true economic effects, as opposed to the market effects? Do oil prices collapse on falling demand, or does the crisis impact oil production, causing prices to remain supported? Does China, the main determinant of commodity prices and Russian export growth, continue to grow at levels similar to those it has maintained for the past 20 years? If so, we can feel quite confident, given the fact that Russia is a major beneficiary of Chinese growth.

Ch. One: Coming back to the previous global crisis... Do you subscribe to the official description of the crisis as "*economic*" or do you think the roots of the crisis go beyond the economy and have to be viewed in the broader context of culture and politics?

E.K.: The financial crisis was ultimately driven by the fundamental changes occurring in the global economic system. The loss of the primacy of the West – with the secular rise of China and the Emergings – is having a profound effect upon all economies. The sunset countries of the West have been desperately seeking to "*kick the can down the road*", and will continue to delay the recognition of their reduced circumstances for political expediency – at least until this impoverishment can no longer be ignored. Currently it is Greece, Ireland and Portugal who are being forced to face painful cutbacks. Tomorrow, it will be the United States and Japan who will be compelled to live within their means.

The crisis was economic – but economic policy is driven by political and social imperatives. The main imperative for the West was to keep the bubble blowing just a little bit longer – massive credit creation and asset price inflation allowed the maintenance of lifestyles and the phantom of economic growth, long after it had become unsustainable. The question was not *IF* the system was going to collapse, but only *WHEN*. And the collapse is not quite over yet – at some point, we will see a severe fiscal drag as the US is forced to begin slicing into its mammoth budget deficit, possibly accompanied by monetary tightening if inflation continues to tick up.

Ch. One: What measures did the governments of the top countries take to overcome the crisis in the financial and social terms? Which of those measures were really fruitful, if any?

E.K.: By flooding the markets with liquidity, central banks' support of the national banking sectors, and direct government support of the financial and non-financial sectors via bailouts, they broke the momentum of a crisis which risked spiralling into a true meltdown.

Failure to act would have been criminally insane, however, to imagine that these temporary support measures removed the imperative for painful deflationary phases would be equally delusional. The problem is that the political system in several Western countries, including the pre-eminent among them, is so wedded to political hedonism that there simply is not the ability to make necessary sacrifices, at least not until they are forced to do so by circumstances.

Ch. One: How did the crisis impact the national currencies?

E.K.: For technical reasons and questions of market micro-structure, the crisis temporarily reversed what had become the secular, long-term trend – a weakening US dollar, and a rise in the currencies of the more dynamic emerging markets, commodity producers, and the better managed Western economies (Sweden, Norway, Switzerland, but also, the overall Euro bloc). With the end of the crisis, the fundamental trend has reasserted itself. The centre of economic gravity is moving East, and the currency markets are coming to reflect this.

The rouble took a serious hit during the crisis, initially driven by psychological factors and a flight from risk, then by the rapid outflow of credit back to the Western banks. The Central Bank of Russia responded very competently, engineered a gradual sell-off, essentially transferring funds from the state to the banking sector. At present, with Russian domestic markets back on a stable footing, the CBR is tolerating gradual rouble revaluation as they increasingly target inflation.

Ch. One: What is happening in the US and in Europe after the crisis – in terms of the social policy, human welfare?

E.K.: America is seeing a long-term impoverishment of the middle-classes. This was disguised by the increasing leveraging of the economy, growing consumer credit, and, especially, the ongoing rise in real estate prices. All of these have gone into reverse, and there is considerable stress as people lose their middle-class jobs and crash into the sub-proletariat – losing their homes, health insurance, and ultimately, their social identities. Europe has a better safety net, so the process is slower and less radical, but the decline in expectations is palpable. Furthermore, Europe has less flexibility than does the US and needs to trim back and better target its social system to account for the new economic realities. The high levels of unemployment in Europe and the US are very destructive, with people becoming increasingly marginalized during prolonged periods of unemployment.

Ch. One: Do you know of any countries that managed to protect their citizens from the global crisis? And which ones were the worst hit, and why?

E.K.: China was one such country. They were able to use truly Keynesian measures since they had saved money during the good times, and thus could engage in massive stimulus without impairing their solvency when the American subprime crisis struck.

Several of the countries of "Greater China" (Singapore, Hong Kong, Malaysia) also managed to dodge the worst of the storm, as did some of the Emergings, such as Indonesia and Malaysia, which have become far more dependent upon Chinese than on American demand.

Like China, Russia had run a very orthodox fiscal policy before the crisis, so they also had the financial means available to stimulate the economy without risking a debt spiral, however, the momentum of the crisis was fierce, Russian corporations were dangerously dependent upon foreign finance, and the social safety net was less effective than the European equivalent, so there was considerable economic disruption.

Of course, one needs to keep a sense of perspective – just as the 1998 crisis was but a pale shadow of the crisis of 1991, so the 2008 crisis was relatively mild by comparison with those that had preceded it. Encouragingly, the Finance Ministry and the CBR showed that they had learned the lessons of the 1998 crisis, and their handling of the very threatening situation of September 2008 was exemplary.

Ch. One: What can you say about Russia's experience in dealing with the crisis?

E.K.: The Kudrin system – the Negative Carry Trade – was shown to be a very dangerous solution to a very real problem. Given the inability of the Russian financial system to efficiently absorb the huge cash flows the government captured from the commodity sector, the Finance Ministry essentially decided to finesse the problem by opening a foreign bank account, investing the oil export funds in G7 government bonds, especially US Treasuries and agency bonds. This had the effect of starving the Russian corporate/banking sector for funds, forcing them to borrow from foreign banks at a cost far above the yield on its sovereign assets. When the global financial panic hit, Russian companies simply could not renew their credit lines at any price. Fortunately, by repatriating assets parked abroad, the Russian government was able to refloat the banking system and we did not see a banking crisis like in 1998.

Ch. One: Many reports in the Western press warn that Russia is engaged in unsustainable deficit spending, and that it will again end badly, especially if the oil price crashes.

E.K.: It is quite amazing to hear people from countries that are spiralling into debt crisis, with budget deficits around 10%, warning one of the world's most fiscally prudent countries of the dangers of deficit spending! At the depths of the crisis, Russia spent heavily, but from savings – not from borrowings. As the crisis receded, this increase in spending was limited, but not reversed. Some journalists warn that pension spending has exploded – they used to write about the misery of the old ladies trying to survive on their tiny pensions. You can't have it both ways! Russia still has huge unmet social needs, and the government will continue to increase spending to bring living standards of the poor up to European levels. Contrast this with the massive subsidies handed out to bankers in some of our own countries…

As for "*what happens when the oil price crashes*" – that question is about as interesting as "*what happens when the Moskva river turns to lemonade!*" Oil will be volatile, but over the medium term, it is a one-way bet, and we will see prices higher than we can today imagine. The world is moving towards peak oil – it is not a theory, it is a mathematical certainty. No more oil is being created, and what there already is of it is rapidly being depleted. More oil will be found, but it will be found in increasingly difficult and expensive locations… and many of those locations happen to be in Russia!

Ch. One: How can you describe the current situation in Russia's economy?

E.K.: We are seeing the end of the first phase of the Russian recovery. The old model is exhausted, with Russia having reaped most of the benefits of budgetary/fiscal orthodoxy, capture of export revenues, and the overall macroeconomic normalization and resource nationalism instituted during the presidency of Vladimir Putin.

The initial success was spectacular, but a new approach and far more effective reform process is now vitally necessary for Russia to resume growth at pre-crisis levels. I am not certain that diversification of the economy is a valid goal in itself – but certainly the reform of governance, the legal and regulatory systems can no longer be delayed. It was never going to be easy… but there is reason to hope that the spectacular progress seen since the 1998 crisis will continue – Russia is not China, alas – but, equally, it is far more dynamic than most of the G7.

Ch. One: What challenges is Russia facing from abroad – politically and economically? Must Russia look to the West for its models?

E.K.: While the official discourse of the countries of the West is "*caring and sharing*," with much talk of the mutual benefits of cooperation, the reality is rather different. Like imperial powers throughout history, the once-dominant powers of the West seek to subordinate other states to their own purposes; the childlike fascination with the West of some of the Russian liberals is naïve and dangerous.

As Mr. Putin put it, when you are weak, others will come over and try to tell you what to do, and their advice will not always be in your own best interests. It is not that anyone is intentionally wicked, nor that Russia would act any differently were the shoe on the other foot. It is simply human nature to believe that solutions which benefit oneself are of universal benefit. The fact that the fall of the Soviet Union was an excellent thing is does not mean that its enemies were necessarily any more benevolent.

In my view, the future of Russia is within the BRICs – yes, she will be a junior partner to China in this grouping – so will Brazil and India – but the BRICs group together the new economic powers who are challenging the dominance of the West on the international scene, and this is currently the best forum for Russia to participate in shaping the New Economic Order.

Ch. One: What do you think about the polemic arguing that Russia still supposedly poses a threat, particularly coming from such writers as Edward Lucas?

E.K.: You should consider track records – not just for fund managers but also for journalists! Lucas has been systematically – indeed comically – wrong about Russia since 1997. He is married to his political positions, and his entire worldview is based upon personal spite, and the profound conviction that his particular values are the only valid ones.

There is nothing wrong with making bad calls – it happens to all of us. What is inexcusable is to persist, despite all the evidence to the contrary. In September 1998, Ed Lucas warned me that the rouble was going to 10,000 to the dollar, the Russian economy would collapse by at least 25%, the Communist hordes would seize Moscow, and Russia would break down into four mutually antagonistic, nuclear-armed regions. Of course, this proved to be utter nonsense!

Beyond the personal issues, Russia is an inherently conservative power; lacking natural boundaries, she has historically sought to minimize the very real threat from the West by erecting barrier states. Russia was utterly devastated by the West on three occasions – the Napoleonic Wars, followed by the two World Wars. This strategy ended with the Soviet Union, but like other major powers, Russia will seek to maintain her sphere of influence.

Modern Russia poses no threat to her neighbours, some of whom have difficulty recognizing the fact that the Soviet Empire is gone forever – a restoration of the Soviet Union being about as likely as a restoration of the Holy Roman Empire!

For a citizen of a country which joined the illegal invasion of Iraq on transparently fraudulent grounds, and which has recently become engaged in the Libyan Civil War in a transparent play for oil assets, to warn about the dangers of an expansionist Russia is frankly Orwellian.

Ch. One: Many "Kremlinologists" base their opinions on Andrew Kuchins' report "*Alternative futures for Russia to 2017*". What do you think about the report and what is your own "*prediction*" for Russia's future?

E.K.: I haven't read it. The prostitution of the Moscow Carnegie Endowment, which was covertly funded by Yukos while defending Mikhail Khodorkovsky – one of the worst thugs of an otherwise brutal period – would tend to discredit their objectivity.

More broadly, I would be deeply sceptical of American authorities as regards Russia. Even more than most Westerners, the Americans are deeply convinced of the superiority of their own system, and have little time for ideological diversity. They are born with the assurance that their model is not only the best – but that it is the only possible model for every country on earth. They may be sincere in this conviction, and benevolently inclined, but the results are not always particularly felicitous.

The crazy economic montage of the Yeltsin years was put together with a great deal of Western assistance in the 1990s – and you will agree that the results were fairly catastrophic… I think their advice will continue to trade at a deep discount in Russia.

Ch. One: There is a view that "*modernism*" has moved East, and that West is now post-modernist. Did it give up industrialism for good? Has it moved, recently, towards the problematic financial, managerial, information and other "*services*", beyond the point of "*no return*"?

What do you think and what is your prediction for the future of the US, and the West, in general, and in economic, financial and social terms?

E.K.: Looking at the underlying trends of history, I am coming to believe that the West has a great future… behind it!

The 20th Century was totally anomalous in that the bulk of global GDP was concentrated in the European countries and their colonial spin-offs – the US, Canada, etc. (The sole Asian country of any consequence – Japan – had succeeded by first imitating, then improving upon the Western models.)

This was very much an historical exception. In the 19th Century, the commodity producers of South America and Asia were major economic players – in the preceding centuries, China, India and other Asian powers accounted for a large share of global production. We tend to forget that in the 15th Century, China was economically and technically far more advanced than Europe, with several cities of more than one million people – this at a time when Paris and London housed hardly more than 50-100,000 souls. The great civilizations of the East were temporarily eclipsed by the rise of European mercantilism and imperialism, but the pendulum is now swinging back.

The 21st Century will most likely see a return to the previous norm – a shift from a world radiating out from New York to one with multiple centres – with Beijing the new pole of attraction. A look at history shows that the decline of the dominant empire with the ascendency of new and more dynamic powers has not usually been a calm, beneficent process – the 20th Century saw two World Wars as a result of such processes – and the changing of the guard is fraught with dangers.

Will the Chinese overplay their hand? Will a collapse of the dollar-based economic system cause severe damage to the global trading system? Will the US feel besieged, taking desperate measures to restore its declining hegemony? And, more fundamentally, will burgeoning population coupled with explosive global economic growth not end up colliding with the very finite resources of our planet, resulting in ecological havoc? The day that 1.3bn Chinese start their SUVs on the same morning, the earth will have become a vastly different place.

As always, T&B would remind our readers that they are invited to forward our reports to any party.

For back issues of T&B, and further discussion, please go to www.truthandbeauty.ru

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