CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

RUSSIA’S ECONOMIC MELTDOWN: CONSEQUENCES AND PROSPECTS FOR THE FUTURE

WELCOME AND MODERATOR:
ROSE GOTTEMOELLER,
SENIOR ASSOCIATE,
CARNEGIE ENDOWMENT,

SPEAKERS:
CLIFFORD GADDY,
SENIOR FELLOW, FOREIGN POLICY,
BROOKINGS INSTITUTION

BARRY ICKES,
PROFESSOR OF ECONOMICS,
PENNSYLVANIA STATE UNIVERSITY

MARK MEDISH,
VISITING SCHOLAR AND SENIOR ADVISOR
CARNEGIE ENDOWMENT

WEDNESDAY, JANUARY 28, 2009

Transcript by
Federal News Service
Washington, D.C.
ROSE GOTTEMOELLER: Okay, if you will take your seats, we'll get started. Good afternoon, everyone, and a very warm welcome. I am obviously not Ambassador Jim Collins. Jim had a family situation to take care of today and he will be along a little bit later, so I expect to see him before the end of the session but he couldn’t join us for this opening and so I am taking over the chair this afternoon.

My name is Rose Gottemoeller; I’m the senior associate of the Carnegie Endowment for International Peace, recently returned from Moscow, where I was the director of the Carnegie Moscow Center for three years. Usually I don’t do economics issues, so I’m looking forward to learning as much today as many of you. I just noticed that I grabbed this folder to carry my papers down in and it says Russia and no-first-use policies, so you have an idea what I normally work on, which is nuclear-weapons issues. But I’m very pleased that we have the opportunity to wrestle with this topic today: Putin’s system in a regime of low oil prices.

We have, you know, a lot that has gone on; there’s been a real rollercoaster internationally on the economic front, but obviously with Russia there has been a very severe rollercoaster going on and I think many of us, where we’ve paid attention to the news reports and so forth, we wanted to delve deeper and really get a good idea or try to get a good idea about what the top analysts think in this area.

And I’m very pleased that today we have among the three top panelists on Russian economic issues Clifford Gaddy from the Brookings Institution, who has been specializing on Russia for many years. He is an expert who holds a joint appointment as a fellow at the Brookings Institution’s foreign policy studies and its global economy and development program.

He is also a founding member of Brookings Center for Social and Economic Dynamics. He has a book coming out with Barry Ickes: “Russia’s Addiction: The Political Economy of Resource Dependence.” And this presentation today will draw on the work that is going into that book and I think it will be a very exciting and interesting book once it hits the streets. I just wanted to mention to Cliff that through all my time in Moscow over the last three years there was a constant drumbeat of interest in your book on the cost of the cold. So that’s very popular among Russian experts for some reason; I thought it was extremely interesting.

Barry Ickes, Pennsylvania State University, is a professor of economic at Pennsylvania State and financial director at the new economics school in Moscow. He previously served as the chair of the board of directors of the National Council for Eurasian and East European Research and in that role I know many of you have worked with him and know him quite well.

And my good friend and colleague, Mark Medish, is visiting scholar and senior advisor here at the Carnegie Endowment. He served in the Clinton administration as special assistant to the president and senior director for Russian, Ukrainian and Eurasian affairs on the National Security Council. And so he brings that perspective of having had a government brief to handle as well.

And so I think we will get some varied views today; we will hear presentations from Cliff and Barry and then some comments from Mark and then we will throw the floor open to your questions and comments. So I look forward very much to our discussion and welcome. Thank you. You’re going to start, Barry, okay.
BARRY ICKES: Thank you, Rose, thanks to everyone for coming out here on what for you must be a difficult weather day, although for me is pretty mild weather. We’re going to sort of do this as a team; as you can hear, my voice is almost nonexistent and Cliff doesn’t have a right arm, so together we make one economist – none of that two-handed economist joke. Okay, so let me – I’m just going to briefly give an introduction and then turn it over to Cliff but I’m going to still stand here.

Let me just say, the official title was “Russia’s Economic Meltdown” and Cliff and I were thinking, you know, Russia in the world economic meltdown, because one of the things we’re going to talk about is how Russia has fared in the face of events that have come from the rest of the world. So brief – thing we’re going to focus on economic policy. We will try to understand how that works in terms of Putin’s policy and Putin’s system. It’s clear he’s an axiom of the discussion, at least until we get to Mark, is that he’s the unchallenged CEO of Russia. We’re going to explain Putin’s system; we’re going to explain how his policies and priorities and instruments are used to develop the system in his way.

And our focus is really on this system and how robust it is. And then the question we’re really concerned with but it’s still somewhat to be figured out, is how this system will work in this new regime of post-bubble low oil prices. What we’re going to talk about first is how well Putin’s system has performed; can it continue? We can see to some extent it’s robust to the crisis, but can it be adapted, because that says something about the future political economy of Russia – whether this system can maintain, whether it will be stable, whether it can be adapted or whether it will have to be replaced.

So I’m going to – that’s about as much as I can speak until you people respond and then I’m going to have to jump in and get back at you. So I’ll leave it to Cliff, but I’m going to stand here and be his right finger.

CLIFFORD GADDY: Thanks. As Barry said, what we’re really going to be talking about is economic policy in this – what we call Putin’s system or Putin’s model. We’ve written about this in an article in the National Interest if – some of you may have read it – I encourage you to read it because hopefully it will present these ideas in a bit more coherent and clear form, although without any graphs and charts, which may be the advantage of today’s presentation. So let me just quickly sum up what we argue is Putin’s system – the way he’s managing this economy.

And begin with what we would say is four key premises in his mind. Number one is that the economy is key for Russia’s strength in the world – not its military, not all this other stuff that was in the Soviet day – the economy. Number two: If that’s true, the economy should be as strong and efficient as possible and that has implications for what kind of an economic system you have, because Putin, as I’ll point out, is convinced that a Soviet-style economy – central planning, state ownership and so forth – is not the way to a strong economy. It proved itself in the Soviet period to have a weak economy.

Third key premise is that the economy has to ensure the priority of state interest, which of course is not always the case – in his mind – in a pure market economy with private ownership. So something has to be added. And a fourth point – extremely important, of course, for the current talk and current situation – is this economy has to be robust to crisis and kind of a worse-case-
scenario-type crisis. I’ll get to that in a minute. So the efficiency point is the point I made that Russia does need a market economy with private owners.

The part about the priority of state interests is simply the conflict between so much economic power in such a highly concentrated economy with resource industries, that to simply turn this over to efficient owners and managers leads to a contradiction in the prioritization of state interests. And somehow you’ve got to solve that dilemma: maintain priority of strategic state interests without impeding the efficiency of a market economy. But let’s get to priority three, this notion of being robust to crisis.

And the kind of crisis I’m talking about could literally be life and death – survival of Russia as a nation. And the historical memory most recently is that of the 1980s and the 1990s. The point there that said that Putin has read Gaidar’s book – Brookings published the English translation of a book that Yegor Gaidar wrote a couple of years ago called the demise of an empire – the fall of an empire, with a subtitle that’s most important: “Lessons for Today’s Russia”. And that book, of course, was not about the 1990s when Gaidar was prime minister, when he was active in politics in post-Soviet Russia; it was about the late years of the Soviet period. Those are the lessons that he was giving to Mr. Putin and which we argue Mr. Putin has actually tried to take to heart.

Well, the straightforward solution to solving – avoiding a repeat of the crises of the ’80s and the ’90s is to make Russia financially sovereign – financially independent by paying down the debt, building up the reserves. And the combination of all these things – reconciling the efficiency, the state control, the robustness to crisis – three things that are inherently in tension almost in any bipolar combination of those three – is something Putin, I think, actually believes he has found the only – he’s the only person to have found the answer to this and in particular this notion of preparing for a crisis.

He has a nice little quote, which he gave in October I think – you may not be able to read it out there, but he’s bragging that everybody in the world was caught off guard by the current crisis, not just governments but the IMF, everybody else were unprepared. I’d like to say that, “We did not allow ourselves to be caught by surprise…We took into account the potential risk and threats.” In fact, we were criticized – we being the royal we – we were criticized for excessive conservatism – he’s referring there to building up these foreign-exchange reserves – massive reserves – and yet I feel that “conservatism proved justified.”

This notion that the policies he has pursued over these past eight or nine years have been vindicated by the current crisis is an ongoing theme in many of his remarks. Now, let me just get quickly to some of the points that we talked about as following from – as instruments for achieving his objectives, those top priorities. The notion of how can you control – how can you harness, if you like, the advantages of private owners in your economy without sacrificing the control of at least – that they pursue strategic interests that you deem important for the nation as a whole.

Barry and I have written about this, we’ve written preliminarily about it in some of our articles and this will be a centerpiece of the book we’re writing: He’s essentially set up a protection racket – a property-rights protection racket for a very limited, select group of private owners, the so-called oligarchs – the top oligarchs in the economy. That is, as long as they are willing to play by rules that he lays down – and there are some very specific ones, and I’ll get to that in a second – they are protected against a much worse outcome. He’s already foreshadowed in a couple of cases what
that outcome could be; not just Gusinsky and Berezovsky but of course Khodorkovsky’s case looms large in the minds. However, if you play by the rules you’ll be okay.

Putin, by the way, in an interview with Bloomberg on TV a couple days ago repeated exactly the same statement when they asked him are you glad now this crisis is going to maybe eliminate all the billionaires in Russia. And Putin says, what is this, how did this rumor get started that somehow “I’m a destroyer of billionaires.” He said I’ve never had anything against billionaires, that’s never been my objective. If they play by the rules they’ll be okay. If a person can accumulate massive wealth still playing by the rules then God bless them – God grant them health. So Putin gives orders to God to protect them as long as they play by his rules. (Laughter.)

Now, let’s go to this – what is the deal that made with the oligarchs? I mean, just very briefly. On the one side, what he’s doing for them is they get to keep their property. They can make their companies more productive, they can get richer and they would be protected against expropriation or worse. That’s what he’s giving them. What are they giving him in return – and this is the deal that he laid out in the famous meeting in July of 2000 – first and foremost they need to do something they had not been doing before, which is to pay their taxes in cash in full. This was the end of the virtual economy days in which they were engaged in all kinds of funny business with ways in which they paid or didn’t pay their taxes.

Don’t try to change the tax laws, which he had painstakingly implemented, don’t collude with the governors to divert the income away from the federal center. Furthermore they needed to share their wealth informally in ways that Barry and I describe as informal taxation, so in addition to paying their formal tax, they needed to engage in informal taxation. Philanthropy being one, the so-called social programs, but also excess costs – placing orders with some of the big dinosaur industries throughout the country – social and political purposes for doing that, not economic.

And finally, let Putin make the strategic decisions for these companies – the really important strategic decisions. This would be a very, very limited sphere in which Putin might weigh in, but if anything was deemed by Putin impinge upon Russia’s strategic interests, especially in foreign policy, they needed to clear that with him. The protection racket is necessarily limited to the rent-producing sectors; it makes no point to engage in the effort that’s required to engage with these private owners of large enterprises if there’s nothing to be gained in return. And with Russia, an economy in which the rent- or the value-producing sectors are so highly concentrated, it is in a sense ideally suited to such an approach; it would not work in other economies.

He can limit himself to dealing one and one with literally a handful – maybe eight, maybe 10, maybe 12 or so – of these top oligarchs and achieve what he needs to do. Why, you might ask, does he not then – if this works and we argue that it has, at least up until now – why not expand the circle of private owners? Well, it’s simply what I say: that it is costly to engage in this and the payoff to do it would be low. And this has the interesting and very important effect that a protection racket exists for a very small number of private business owners in Russia – the oligarchs; nothing like that exists for the rest of the economy.

And the idea that rule of law would be implemented in Russia is completely contradictory with this system. It’s unthinkable that there would be one set of rules that Putin has for these large oligarchs and another set of rules – the rule of law – for all medium-sized and small-business people throughout Russia. They could not coexist and that, I think, is the real explanation why, despite lip
service to rule of law, lip service to promotion of small- and medium-sized businesses, they are completely exposed to shakedowns and protection rackets of their own by the mafia and by government employees, including local law enforcement, FSB circles and so forth.

But let’s look now – that’s a brief description of what constitutes the model – let’s look at how it has performed. It may be convenient to break this down into three or four phases. Phase one from 2000 to 2004, key thing there, oil on average for that period, world oil price was $32 a barrel. Phase two, 2005, ’6 and ’7: Oil average price was $62 a barrel. And what might be called a very brief phase succeeding that – phase two A, if you like, extending just the first half, roughly, of 2008 – for the first half of 2008 through August the average oil price was $107 a barrel. And then finally the current phase, after the crisis, after August of 2008.

So let me look at these individually very quickly now. In phase one – in a way this was the simplest time. The priorities were simple: First was to establish the control over the oligarchs, that is, set up this property-rights protection racket and also institute the tax reform that was in effect part of this – an essential part of this, collecting those formal taxes to the center, the property-rights protection racket among other things, collecting the informal taxes to the center. So you set that up and make that work.

And then secondly, what do you do with the resources you now have collected into the federal center? Your top priority – almost your exclusive priority – is to achieve this financial independence, so part of your robustness – achieve financial independence by paying off the government debt – paying it down as quickly as possible, which is exactly what it proceeded to do. In a way, you can look at this story of the relationship between Russia’s foreign currency reserves – foreign exchange reserves and Russia’s government foreign debt as marking a nice boundary between the two key periods of Putin’s regime; the red being the foreign debt, the blue being the foreign-exchange reserves.

And exactly the tipping point, when finally you have achieved a situation in which the reserves exceed the debt, I think it roughly coincides with what we see as a shift into a new phase – phase two: 2005, 2007. What’s the main event? The main event is a completely different situation than had existed before with respect to the world oil price, what can be described as nothing else but a real windfall. The turning point occurs something like in the middle of 2005 as – I mean, this is arbitrary, but the oil price there exceeds $50 a barrel and after a very, very long period of oil prices down at around $25 a barrel – these are 2008 prices, so these have been adjusted for inflation.

So in that second quarter of 2005, as oil moves over $50 a barrel and stays over and rises quite highly despite some initial ups and downs, things really change in the Russian economy and causes certain changes or adjustments in Putin’s economic policy. Now, one thing remains the same – continue to pay off the debt. Key events there are paying off the IMF debt three-and-half years ahead of schedule – three-and-a-half years ahead of schedule, unexpected by the IMF.

I pointed out that I don’t even know if you can still do this, but you used to be able to go to the IMF Web site and call up the payment schedule for the Russian Federation. And it still listed payments going into July of 2008, you know, years after they had already paid it all off at the beginning of 2005 – and then, later, paying off the Paris Club debt.
However, as the oil price rises, and really soars, you’re having to adjust in a way that you had not expected before. You continue to tax the oil windfall and set up an oil-stabilization fund. What are you going to do with all of this surplus? So, of course, in 2004 you set up the oil-stabilization fund and it really comes into full swing in 2005, continues to 2006 and 7.

If you look at the gross sales revenue of all Russian crude oil, exported crude oil and exported oil products, these are the gross revenues. So out of these revenues, these companies have got to pay all of their costs and have some – retain profits, pay their regular taxes. The stabilization fund was collecting about 40 percent of the revenue, so truly soaking it up into the stabilization fund during those years.

What happens in 2008? Nothing goes into the stabilization fund. A very interesting point I’ll come back to. Another policy though, back as the oil price rises, is we argue in another article that we’ve written recently – Barry and I argue – that it’s well-known that Russia’s physical output of oil, its oil production, stagnated and actually in the last year-and-a-half or two years, has turned into slight negative. It shrunk slightly. And this people ask, what’s the reason why? This is really stupid. Why did Putin have such high taxes that deter companies from producing more oil, investing in expansion of production?

We actually argue that that indeed is one of the effects of the taxation policy and other policies, the increased state ownership in the sector, but that this was not an unintended effect of this, this was not either a necessary evil or an unintended consequence of policy, but that it actually was an intention.

The idea was, the rents were already growing so fast, they were already so difficult to manage and handle, that the best thing to do is just keep the oil in the ground. Oil prices are going up, they will continue to go up; that was the consensus. Why pump the oil now at high expense and cause headaches about how to deal with the surpluses that are earned from that? Simply keep it in the ground.

Russia did not want to risk what we describe as the addiction that comes from more oil rent in the economy; industries, especially producing industries, feeding off of this wealth. And, of course, it did not want to expose itself by venturing into new expansion of production of what might happen with a fall in the world price of oil.

But another point that you had to deal with during this period of the massive explosion of rents that started in 2005 is how to intermediate these financial surpluses. And here Russia did something that is by no means unique for Russia. It was the same thing that was done by the Gulf oil producers, especially by the Chinese, who earned their surpluses in a different way, but still had the same problem. All of these countries faced a thin and weak, fragile and inefficient domestic financial system.

And in all these cases essentially what’s happening is countries were using the international – the global financial system to intermediate their own financial flows. So you have this curious situation: Russia pumps the oil, sells the oil to the West at these rising, soaring prices, earns the money, lends it back to the Western governments and then Western banks lend it back to Russian private corporations. It’s a curious cycle there but makes sense in the context and becomes quite important, of course, when this whole global financial system collapses. And it’s just kind of
interesting to see that Russian private debt, as opposed to that state debt that was being paid down rapidly, just explodes and grows almost dollar for dollar in the same amount as the increase in export revenues that the country was earning.

Let’s move now to what happens then at the beginning of 2008. This whole system looked quite successful into 2008 and indeed there was a period in which Russia could look at the global financial crisis and say that we’re better off than the rest of the world. In May 2008, U.S. and other stock markets begin the downward slide that they are still in and for a brief period the Russian market – the RTS and other indices – actually stayed up – down slightly, but really were staying up. Why? It’s because the global oil price kept going up; in fact, reached its historic highs, as you recall, there in the first days of July.

But this was the period in which Putin and other Russian leaders said we are the safe haven. Everybody else is falling, collapsing; we’re the safe haven. That was a very, very brief period of saying that, because as soon as the world oil price began to collapse, then Russia’s collapse was even more marked – as we’ll see in some – but this bubble mentality that had afflicted the rest of the world and apparently had not – to which Putin had not succumbed as he built up his stabilization fund and collected the windfall, as we saw in 2005 and ‘6 and ’7.

There’s an abrupt shift of policy in 2008. As I said, no longer anything going into the stabilization fund just as the oil prices are soaring even more and there are other indications, including some of the statements that Putin made in February of 2008 as he talked about – he bragged about how the RTS – the Russian stock market’s capitalization had grown by a factor of 22 – by 22 times since 1999, as if this was something to brag about. He should have been warning about that, that this is obviously – doesn’t make any sense at all. And it is a bit of a mystery what is going on there, but it does appear that once the oil prices reached $120, Putin followed conventional wisdom around the world.

At the time, as you remember, people were more likely to be predicted $200-a-barrel oil than $100-a-barrel oil and perhaps he also assumed that oil was not – although it might go down – it was never going to return to those prices that you saw in the 1980s and 1990s. Well, the bubble burst and it has been noted that the Russian stock collapse leads the world. There you see a list of countries – you probably can’t read the names – everybody’s down but Russia leads the pack, down over the year 2008 by almost 80 percent. And yet, I think one needs to look at this in a particular perspective because you can’t have it both ways.

If the pre-August 2008 boom in Russia and most notably in the stock market was a bubble, then its huge collapse is not so much a sign of poor performance in the collapse or after the crisis, but rather it’s a sign of the size of the bubble – there was more to be deflated. And indeed, this whole thing is a result of the interdependence of the Russian economy with the rest of the world. The RTS is now roughly back where it was in the fall of 2003, so in other words – it had been growing at a nice, steady clip between ’99, 2000 and 2003 and into 2004, but it was this bubble that occurred beginning later than that.

It’s come back down; perhaps it’s overshot as inevitably will happen in these sorts of corrections. But, again, look at it in the perspective of the bubble and how far it’s at. Now let’s quickly look at the issue of this current crisis. It’s very common to talk about that the Russian crisis – both crisis of it’s stock market, crisis of it’s currency, crisis of its depleted foreign exchange
reserves and so forth – is very much connected with certain political events in Russia or economic events – the Mechel crisis in July and of course the Georgia war in early August. And indeed there is – at least if you look at the picture you see, yeah, the stock market went down, the currency fell, the foreign exchange reserves – there was an outflow of capital at this period.

But, again, this is looking, you know, this is typically when you look at Russia as a Russia person and fail to realize what’s going on in the rest of the world. And August the 7th was the day when virtually every currency in the world had some of its largest declines against the U.S. dollar in recent memory, including the euro. And in fact the euro fell more in the week after the Georgia invasion than did the ruble so, you know, who’s to blame there? The Swedish kronor did, the Norwegian kroner – there’s a whole bunch of poor guys that by that argument are the victims of the Georgia war.

We argue that, look, just put this in the perspective: This is all about the oil collapse. It was financially integrated – Russia was with the West, it was certainly integrated in its trade flows and its sales of oil. The international financial crisis called the oil collapse and that feeds back into Russia. Again, if you live with the ups, you got to live with the downs and the oil and the Russian economy – oil and the Russian stock market provide an interesting comparison there. Quickly let me just talk then about this notion of what’s happening with ruble since, again, this is often described as something very specific to Russia or that Russia is suffering worse than anybody else – that is, you know, by comparisons Russia still lies somewhere in the middle of the pack in terms of the depreciation of its currency against the dollar.

Many famous, notable countries are worse off than Russia – the pound, the Australian dollar – I could go through a whole list – have lost more against the dollar than has the ruble. On the other hand, there are some that have lost less. What’s interesting is this whole policy that Putin pursued with respect to the devaluation it was, not just in retrospect but many, many people were pointing out – you stuck far too long to defend the exchange rate of the ruble in the face of an impending reality that it’s going to have to be devalued and if, you know, your spending is costly to defend it, you’re depleting these massive foreign exchange reserves that had been built up that were then the third-largest in the world. They are still today the third-largest in the world but you did end up spending a couple hundred billion dollars.

Was it really worth it? What was going on there? If you knew it was going to be devalued, why not just shift to a floating exchange rate to begin with? You know, people debate this; I’m not sure we can give the definitive reason. Protect the population, fear of inflation – yes, indeed – give time for the public to adjust. Putin made a speech at one point saying, you know I don’t think it’s necessarily wise for people to keep their money in rubles. They can choose what they want to do with their money: You might want to keep it in dollars or euros or whatever. So it was a sort of tossing the ball back to the public.

But certainly protecting the oligarchs would, according to our model, have been an important part of this, that is, with those massive foreign debts they – dollar-denominated, largely – foreign debts they had taken out over this period, the idea of give them time to adjust their positions is important. And, you know, this is an interesting point, because with that heavy debt burden that they had incurred over those years and this shock that occurred – and one of the first bailout measures that Putin announced unilaterally – claiming that he might have consulted with someone
but it’s not clear if he did – he had a fairly massive program of guaranteeing the foreign debt – the
foreign loans taken out by the private corporations.

I think one has to ask, well, wait a minute – if Putin was, as he said in that Bloomberg
interview – had been described as the destroyer of the oligarchs, he’s lusting for their property,
wants to nationalize it, wants to eliminate them – wouldn’t this have been the perfect occasion to do
it – allow them to default, seize their assets? But, in fact, he did just the opposite and we argue that
that indicates that he’s very committed to keeping this system of the oligarchs remaining in power
with their property and keeping this protection racket, therefore maintaining his power.

And if you think about it of course, the whole thing has played enormously into his hands
because if he was the protector of these guys before, he’s even more their protector today. They are
exposed to new risk against which only he can protect them. So finally, let’s talk about the situation
now – what’s going to happen with Putin’s model in a price regime – oil-price regime, I’m talking
about. Well, everything does indeed depend on where the oil price goes. We could and it’s always
fun to speculate about what’s going to happen with the Russian real economy – not to mention the
Russian financial economy – in the future, but until we know what’s going to happen with the oil
price, which of course is largely driven with what happens with the state of the global economy – it is
indeed a lot of speculation and maybe just a game.

We can create scenarios and they may be useful if we assume certain oil prices but many
people, I think – and I just want to conclude with this – if we look forward to where things are
going – many people talk about, well, if Russia had diversified, if Russia had not been so highly
dependent on oil it wouldn’t be in this sort of a situation. I just state flatly that there’s no way
Russia could have diversified away from oil in the period we’re talking about, no way that it could
have replaced the value that came from that soaring oil price with any other alternative economic
activity inside Russia.

And given the fact that a diversification program, if ever to be successful, will be a long-term
venture that requires massive investments; in fact, I would argue that would have been a terrible
thing for Russia in terms of the effects of this crisis. You would have made commitments in areas
for which it was too short to see the reward just as the crisis hits. Not that that was the planning
that went into this, but I think one needs to be a little bit realistic about the notion of diversification
from oil; in fact, Barry and I argue that Russia’s key middle-term challenge – and it has many
challenges, but perhaps the key middle-term challenge is not diversification away from oil but it’s
how to ensure continued production of oil – continued flow of rents from oil.

The idea of how to expand or maintain, even, oil production by developing whole new
regions in the country has been essentially put on the backburner, has been postponed during the
period of high rents, as I indicated. But that simply means that the urgency is even greater, so what
used to be perhaps a mid-term challenge is becoming increasingly a short-term challenge: How to
ensure the increased production of oil, and especially now with low oil prices, given that Russia is a
high-cost oil producer? This is not the cheapest place in the world to produce oil.

So the low oil-price regime has brought Russia back to reality and the real dilemma is on
how Earth to do this within the confines of the model and the priorities that I outlined. Clearly,
simple economically efficient way to do it is just throw open the doors; invite in foreign operators to
come in and get involved in the Russian oil industry; let them help provide the skill, the technology,
the capital and absorb the risk from this. But that is not compatible, we argue, with his system and so he has to figure out some way to balance these two: achieving the efficiency by bringing in international participation and sharing the risk without undermining his system.

That question – how he will solve that, how he’s look at that – of course remains open as something that needs to be studied. So two points I would make in thinking about summing up the system: how it’s done and where it’s going. Frankly, for eight years the system has not worked badly and at least – and that’s, I think, kind of an objective statement – but certainly, subjectively from Putin’s point of view, he must feel terribly vindicated. He’s the guy who thought about preparing for a crisis; there’s no evidence that any other world leaders did that. He may not have been able to fully prepare for it – that’s one thing, but at least he was thinking in that direction.

His system survived from $30-a-barrel oil to $60-a-barrel oil to $100-a-barrel oil, now it’s still going on, back down to $30-, $40-a-barrel oil. However, that does not mean that it will work indefinitely or even in the medium-term because of this particular challenge that we outlined about the continued production of the oil wealth and the rents. And what are the implications for policies? I know the one that a lot of people are most interested in is whether there will be more liberalization for the economy – is this an impetus – is this pressure to move to what at least some people describe as reform policies but at least more liberal policies throughout the economy.

Our take on this is we think there’s a good possibility that you may see more liberalization regarding oil companies à la Hugo Chavez in Venezuela – that you suddenly shift and you invite the oil companies back. If that happens we would tend to think that it would happen on a very limited and selective basis; there are specific problems that Putin has in bringing in too many major actors. BP proved a big enough of a headache – to have a bunch of BPs operating with the way they caused problems – seen from his point of view – would be a major threat to the whole system.

But even if there is some liberalization with respect to these top-level strategic sectors of the economy and participation of foreign operators we don’t think there will be a general liberalization at all. In fact, quite likely just the opposite, because the protection racket will be tightened to maintain the system in the presence of these external actors that need to be controlled, that is, the foreign companies that need to be controlled in a specific way. And that an alternative policy of, let’s say, seriously promoting small business, medium-sized business, including in the oil sector, in order to win time, say, by developing the western Siberian fields.

Most experts I think agree that there’s plenty of oil left in western Siberia but it could most efficiently be developed only by a sort of a more American-style model of promoting small operators – letting them squeeze some of the last bits of oils out of some of the fields and wells that are existing there. I mean, I just remind you that Russia has roughly 150 companies as operators in its entire oil and gas sector – roughly order of magnitude 150. The United States has 22,000 and that’s mainly the ones at this tail that are very small wells and very small developers.

So that would be at least in theory an option for Putin. That, however, would require a complete turnaround of his economic policies and we don’t think that’s going to happen. So I’m going to stop right there, because I know probably I’ve run way beyond my time to begin with and I’m eager to hear what Mark has to say and comments by others. And unless Barry wants to risk his voice right now, we’ll wait until the Q&A.
MS. GOTTEMOELLER: Okay, you'll hold off. Thank you. You put a lot of meat on the table for us to chew on and I'll turn first to Mark Medish for his comments and questions.

MARK MEDISH: Thank you, Rose, and thank you, Cliff and Barry. I have only praise. I mean, I have been a big fan of your work for a long time and I know you’ve got many fans out here in the audience. For those who don’t know it, these two gentlemen coined the governing phrase for the Russian economy in the 1990s and that was “virtual economy” and they were superseded in the last decade by Goldman Sachs and its moniker BRIC. And I think, really, the question they’ve posed to us today and in their recent writings and in the book is, where does Russia lie between virtual economy and BRIC?

Is it a virtual BRIC or is it a broken BRIC? Again, I’m just a fan. I think your presentation, your exposition is very balanced – acute analysis, very clearly presented. I think you’ve got a coherent theory of the Russian political economy under Putin, what you call the “Putin system,” or “Putin’s Third Way,” I think is the title of one of your articles. How does this authoritarian growth model work? And I’ll leave it to the audience to try to question some of the mechanics of that – I’m sure there are a lot of questions out there. I do think it was wise of both of you to start with a moment of self-awareness about the global context and also infuse that into your analysis, because, as one of you said, this is Russia’s meltdown in the context of a global meltdown.

And, you know, normally people in glass houses shouldn’t throw stones. I suppose, to extend the metaphor, the situation is, we’ve smashed our own windows so we might as well throw some stones at other peoples’ glass houses. (Laughter.) And apropos of that, of course, I believe president Putin is opening the Davos World Economic Forum Summit even today, even during your presentation. Illuminations and words of wisdom have spread from the mountain – from the magic mountain. And it’s a wonderful metaphor, right? The old sick man of Europe is on the magic mountain telling people about the pathway to health. But the shoe is on the other foot because, in some ways, it turns out that we also are capable of virtual economics in the G-3 and that Mr. Madoff could teach Mr. Mavrodi a lesson – (laughter) – at least in orders of magnitude.

But back to Russia. I’m very interested in your sort of final judgment on the broken BRIC. Is it a broken BRIC? Is it going to fix itself, or not? So I’d like you to both – and Barry hasn’t spoken to it – just give us a bit of prediction: How deep is this crisis for Russia? I mean, because we did have a different metaphor – we’ve had this BRIC metaphor for Russia, right? Goldman Sachs and others have done big business selling that image. And by the way, Coca-Cola announced today, or yesterday, that it’s gung-ho on Russia – this is the time to invest more – so some folks think that things – that the prospect – you know, maybe asset valuations are good or it’s like McDonald’s, people buy Coke when times are hard – I don’t know.

Let me throw out just a couple of areas I wish you would comment on just a little bit more, and this might anticipate some questions. I’m glad you brought up monetary policy more in this presentation than you addressed it in the National Interest article, because I think that’s very important. After all, the ’98 crisis started as a financial crisis – monetary policy crisis. And you spoke of the ruble exchange rate issue a bit in the past tense. Do you think we’ve had a soft landing or could this go a lot further? Rule of law, a very important area – the way I pose this question to you is the Putin-Medvedev question: Medvedev has placed a lot of emphasis on the rule of law as important. You seem to indicate that that’s probably window dressing due to the fundamental nature of the Putin system, but I wonder if you see any daylight there.
Third, and building on the risk of social unrest, we saw some outbursts in Vladivostok recently because of import duties. You know, are there – do you see – and you spend a lot of time in the country – do you see risks that social tension could boil over because of the economic stress?

Fourth, the integration theme – what about the WTO? Does all of this mean they really don’t care about it and that that should not be a high priority in the economic dialogue with Russia? And what’s their perspective on that?

Fifth, the geopolitical link – does a less-growing virtual BRIC mean a more assertive one or a less assertive one in its foreign policy? We’ve just been through the gas dispute with Ukraine, which is a bit like Groundhog Day; it just happens every year and people are surprised every time it happens. What are your views on that?

And, finally, here, in the same connection, what about neighborhood contagion, because in the ’98 financial collapse, it was not only a problem for Russia, it was an enormous problem for the Eurasian neighborhood. It was a problem for its FSU neighbors who had a lot of exposure to Russian assets, the banking systems in places like Kazakhstan, Ukraine and so forth.

So those are my little comments. One last thing – on the diversification versus oil, I think it’s a bit of a red herring in that “both, and” would be an acceptable answer and a good, strategic answer for Russia. It’s got to get the oil equation right and diversify. And I think you hinted at that at the end. Thank you.

MS. GOTTEMOELLER: Thank you very much, Mark. That is an excellent list of questions. And I imagine some of you have been thinking of those as well. Would you two like to take a shot, at least an initial comment on that list? Or shall we open immediately?

MR. GADDY: Can we just give like one-line answers?

(Laughter.)

MS. GOTTEMOELLER: Okay. (Chuckles.) And that might then generate some more comments and questions from our audience.

MR. ICKES: Well, I thank Mark for those comments, some very nice comments. The thought of the broken BRIC, I think it’s –

MS. GOTTEMOELLER: There’s a microphone, if you could.

MR. ICKES: I don’t need a microphone. (Laughter.) It’s only a matter of this cold that I need a microphone at all. I don’t – you know, the important point regarding the broken BRIC is that Russia now is not in the same situation Russia was in ’98 or Russia was at the end of the early ’90s. This crisis is coming – this crisis is the bursting of a bubble. So Russia is back right now to levels that were pretty good when it reached it on the upswing. So it makes every – you know, evaluation of the consequences dependent on what’s going to happen in the future with oil prices and these medium-term challenges.
You know, regarding the ruble, I’ve taught international finance for more than 10 years and so I know I can’t predict exchange rates. So – but I do think that, you know, the period of the help – resisting the depreciation is over. And, again, you know, so I think now there’s much more accommodation to the other period.

Now, I think the real question, the really interesting point you made – and then I’ll turn to Cliff – but the real interesting point is, talking about priorities at WTO versus other things. And I think here the G-20, you know, the idea that the real sort of intersection of interest, you know, the way in which cooperation can happen is a new idea. I mean, it’s about how do we reform international financial architecture, you know, the balance of – the whole configuration of world surpluses and deficits has shifted from what it was in the creation of the Bretton Woods system.

And so not only do we have an international financial system that has problems in the wake of this financial crisis, but also we need to have good ways of intermediating financial flows from the patterns of surpluses and deficits that we observe, primarily surpluses in China, Russia and petroleum-producing countries and deficits in the more industrialized countries. And that leads to a whole range of issues with regard to sovereign-wealth funds and all sorts of reforms, international financial architecture.

To the extent that Russia is involved in that, I think that’s where real cooperation could be. You know, there’s two models for how this will happen. One is, you know, we’ll decide; tell them – or the G-20 and then you’re really in the BRIC world. Together we’ll work with this new summit in April. If Russia is a player then I think its attitude looks different.

MR. GADDY: Well, on this rule-of-law, Putin versus Medvedev, is it window dressing or is there really potential for some daylight? I think the desire is that there be something real with it like many other things that are being discussed and brainstormed about in Russia, good things. The reality is that the priorities of this system that Putin has will always trump anything else. His dream is always, can he reconcile the seemingly irreconcilable? The reality is that, when it comes down to it, he’ll always choose the preservation of those priorities that I identified. So they’ll coexist but in terms of implementation, it’ll be a different story.

On the question of the social unrest, I know that that really is – I bet there are a lot of people in this room that that’s really what they are interested in when we talk about the Russian economy. And I simply will confess, I don’t see how I can make any predictions whatsoever about that that are any more intelligent than – certainly not any of yours and probably not any more intelligent than those of my 14-year-old son. It is such a guess-work. I just don’t know science that indicates it and, rather, what is needed is simply on-the-ground, objective analysis of what’s going on.

My colleague at Brookings, Igor Danchenko, who I think is here – he’s supposed to be. Yeah, Igor’s here. I don’t know anybody who looks at this more closely than he does. And he just came back from basically a month in the regions in Russia. I encourage anybody who is seriously interested, you might want to talk to Igor. He has a lot of observations which are probably worth more than my speculation.

On the geopolitical question, will this crisis-ridden Russia be more or less assertive? We had a line on this in the National Interest article, which I will still to, which is that the issue of whether
or not Russia is economically strong in any sustainable way, in any meaningful sense or weak I think has very little correlation with its behavior. A Russia that is demographically falling apart, that’s drunk, that’s all kinds of other things, that’s a weak Russia, but I don’t see that being necessarily less assertive or even dangerous Russia. I mean, how much else do you have to do have to press one of Rose’s nuclear buttons?

I mean, it’s – these are unconnected and there’s a lot of other things that can be done without necessarily fundamentally economic strength. We say in the article that the real issue for Russia’s assertiveness, its resurgence and everything else people refer to, is achieving the financial independence, that financial sovereignty. And that is still there. And that, by the way, sets definitely a lower bound for the depletion of the foreign currency reserve. They will – Putin will never allow those reserves to be depleted back to anything like what the levels of the 1990s were.

Neighborhood contagion – well, just the general answer to that, since you probably know the answer to that much better than I do, is there’s no question. With economics that are that tightly connected, as they are, indeed, there is the contagion. So both of these neighborhood countries and Russia are primarily suffering from the effects of the global crisis and some of them – Kazakhstan and others – the same commodity effect. And then, in addition, they are suffering from each other.

The diversification – Mark, yeah, absolutely – do both: diversify and invest in oil. But, you know, there’s a tradeoff there. Every ruble that goes in one way doesn’t go the other way. And I think one way maybe to square that circle is the idea of a diversification that builds on your strengths in the oil, gas and energy sectors. You actually development human capital as well as technologies that both serve your existing strength – your oil-and-gas sector – and have the potential of leading further. That may seem like a facile answer, but it maybe has sense.

MS. GOTTEMOELLER: Pleased to start, anyways, we’re now throwing open the floor for your questions and comments. I see some hands already. The first hand I saw is Wayne Merry’s. So, please, Wayne.

Q: Thank you. Clifford, would you talk a bit more about the potential impact of Russia’s para-statal external debt? I mean, although it’s not technically sovereign debt, a lot of the companies in which the Russian state is a very major shareholder have enormous external debts, a good deal of that coming due in the years ahead.

To what extent do you view these debts as de-facto even if perhaps not de-jure a claim on the country’s exchange reserves? How much might that actually deplete those reserves with implications for the ruble, with implications for domestic inflation and potentially as a danger to this system which you have so well described?

MR. GADDY: Should I take that now? Let’s collect a few.

MS. GOTTEMOELLER: Why don’t we collect a few because I sense there are a lot of questions out there. So Andrei Piontkovsky –

Q: Thank you, Rose. Clifford, in your model of Russian economy you separate very clearly a group of 10, 12 oligarchs from one side and another entity, Putin alone as the highest state servant,
benevolently racketeering, protecting them. But it seems that the picture is more fuzzy. First of all, Putin is not acting in this role, not alone, but together with his buddies. And if you look at the list of these 10, 12 oligarchs, more than half of them – Sechin, Chemezov, Yakunin, Kovalchuk brothers – are now these same, his buddies. And a lot of growing evidence that Putin himself is one of the most prosperous oligarchs.

I mentioned – (inaudible) – report or, for example, Abramovich evidence in London high court. So don’t you think that the picture is a bit more sophisticated than one man against 10, 12 oligarchs, I think, at this state?

MS. GOTTEMOELLER: And we’ll take a third question from Celeste Wallander.

Q: Thanks very much. Thanks for this terrific presentation. And I just want to – I’m going to ask a question, but I’m going to follow up for Mark because, on the social-unrest question, yes, who knows? Yes, it’s tough to guess, but can you say a little bit more? I mean, what will probably spark social unrest if it happens is a collapse in the real economy, that there will be larger problems in the economy that average people, you know, oligarchs might have lost some of their value, but they’ll be okay. But will wages not be paid, will pensions not be paid, that sort of thing which could then feed into that?

But my question is about foreign policy and, in particular, whether there are foreign-policy instruments of the West? If the Putin protection racket works really well within the economy – and there has to be control – not rule of law; that makes a lot of sense. Nonetheless, your very persuasive argument about the interdependence of the Russian economy suggests that, for example, the Putin protection racket depends on control and the protection racket extending, say, through Gazprom ownership of the gas pipelines in Europe, Gazprom ownership of facilities and distribution networks in Europe.

Is that the point – is that where the Putin protection racket could begin to unravel as it encounters sort of Western European push-back – if Western Europe is finally ready to push back on the energy front – or sort of this integration, the terms of integration in the international economy? Or can it exist by itself? Does it work okay on a national basis? Is there really no policy instrument there available to the United States and Europe?

MS. GOTTEMOELLER: Okay. Why don’t we take that group of questions and then we’ll go on to our next phase. Please, Cliff?

MR. ICKES: Okay, first, regarding the para-state debt, I suppose, in some sense, that’s kind of like, we learned that experience from the Fannie Mae and Freddie Mac debt. And, you know, Gazprom debt is even more state debt than Fannie debt. So those are critical and those are, you know, potential claims on reserves. What it does is it tightens this bound that Putin has to worry about before losing financial independence.

I mean, there’s no way he cuts them loose. I don’t think – the only way that, you know – the only alternative is default, and I don’t see default on foreign debt as a likely alternative. I mean, even in ’98, default on foreign debt wasn’t a preferred option, and I don’t think it’s here, because, in some sense, this reliance on this recycling and private capital inflows corresponding to public external
investment has this nice advantage of making the members – you know, tightening the protection racket, because it allows Putin to offer more protection to people.

So I don’t see cancellation of the debt. It does pose a big problem, or an additional problem, but if oil prices stay at $40 a barrel, these things – I don’t see it being an overwhelming – it just limits the extent to which Putin can use reserves for other items.

MR. GADDY: Okay, Andrei’s question about, is this an oversimplification – of course you’re right, Andrei, it is because it’s like a model. But you asked important questions. I would not describe Sechin and Chemezov as oligarchs. They are not private owners; they are not of the same stature of these – the ones who had self-organized in that period of ’96-’97 with the loans for shares, and that was the organization that Putin essentially takes over and whips into shape and harnesses.

Sechin is part of the managing board of the protection racket. I mean, the managing board of the protection racket and the rent distribution consortium – whatever you want to call this Kremlin Incorporated. That’s the seven deputy prime ministers – or however many it is – with the two first deputies. Important guy – Sechin is one of the really important people there. He’s not as important as Zubkov, in many respects, but he’s very important.

And they’re all – they all have an importance there. Chemezov – I like to think of him as – his role in the protection racket is, he’s what he’s protecting you against. You know, the existence of Chemezov is good because man, if you don’t do what we need, he’ll take you over. He has very little to do, obviously, with a desire for efficiency. He’s like the bad – the Russian industrial equivalent of the bad bank idea – just put all the bad assets into one big thing and put it off to the side.

Now, on Putin’s and his buddies’ personal wealth, you know, who knows? I agree, there’s some fairly credible statements about this massive amount of personal wealth that these guys have. All I can say is – I can just speculate about that – I don’t see that at all inconsistent with the way he operates. It’s all about robust to crisis; it’s all about having reserves. If it’s all about having freedom of action, if it’s all about ultimately not letting anybody tell you – having leverage over you, only you having leverage over everybody else, I think it’s perfectly natural that he would have a slush fund of gigantic proportions.

And probably the size of his personal fortune, in whatever form and wherever it’s kept, maybe as a rule of thumb, look up in the Forbes list, find out how much the biggest Russian private capitalist has in personal fortune – if it’s Deripaska, 2008, $28 billion – make sure I’ve got, you know, 28 billion and one ($28,000,000,001). You’ve got to have the ability not to let anybody sit down in a chair against you and say, I don’t have to listen to what you’re telling me because I’m wealthier than you are.

MR. : Of course, the question is how much Bernie Madoff managed for them.

(Laughter.)

MR. GADDY: Celeste, just a brief comment on if the real economy collapsed, no doubt about it: That we know, that if the real economy collapses in any country, you run serious risk and that’s of course why Putin, very quickly by the way, announced a stimulus package. I mean, his
whole – if you look at the list – if you didn’t have any names attached or any country attached and I just gave you a table that described stimulus bailout measures for some hypothetical country and the amount, as percentages of GDP, that were there, you wouldn’t be able to say, that’s Russia.

There isn’t anything specific about it; it’s the same thing everybody’s doing. It’s the same thing everybody’s doing. It’s a mixture of trying to find things that will save jobs, preserve jobs immediately, invest in infrastructure projects, dig up stuff that you were going to do anyway and try to sell it to the population as something new because it’s all about psychology, little faith that this is actually going to work – same thing here. So I think that that sense – and the size, by the way – is almost exactly the size of what we’re doing in this country, relative to our GDP.

So they’re trying as best they can, using international experience to avert this collapse of the real economy, but I would say with as little guarantee of success as any other country in the world, which means that it is a real threat. Now, on this question of foreign policy instruments and foreign policy with the West, I think, maybe, yeah.

MR. ICKES: No, before you – let me just –

MR. GADDY: All right.

MR. ICKES: On the real economy point, I just want to emphasize, you know, it’s kind of an interesting paradox in Russia when you think of it compared to us, because here, our recovery is plagued by the fact of the financial meltdown. Now, the financial meltdown affects Russia primarily through the thinness of the financial system and the, you know, the loss of capital flows. You know, the international financial crisis melts down and Russia de-leverages because it’s got a thin financial system and everything goes.

In terms of the real economy, it’s oil prices and the end of this bubble, right? But it’s not so much that Russia’s recovery depends on rebuilding the financial system; the financial system wasn’t that crucial to Russia’s growth even in the bubble years, you know, except at these margins. So it’s a real hard thing to – I mean, they’re really dependent on what’s happening elsewhere, in some sense, I think you know.

MR. GADDY: Yeah, just real quickly on the question of foreign policy, or – it’s rather difficult, I’ve found, to try to come up with realistic proposals for positive things to do. It’s easier to come up with a list of things not to do, and I really think that it is counterproductive for the relationship with Russia, for our own economic well-being – and this was true before the real depths of the crisis and I think it’s equally true now – for us to try to, quote, “punish” Russia using economic levers – punishing it for foreign policy behavior.

And we should be very, very wary about that, not least because, despite everything I’ve said about this system, there are lots of people in Russia at different levels – in business, as well as in the academic, economic expert community – who are perfectly rational people who would probably react and view, because they know it better than I, this system that they’re living in equally negatively as we might, but they’re trying to deal with it in a constructive way because they’re real problems for Russia. And the worst thing that could happen to them is any sorts of measures that would push Russia away from engagement in the global economy.
This is a good thing, not just for the top of Russia, but for all down society – engagement in all respects. And as far as the economy is concerned, this is the only channel that I think is realistic that we can have some influence on that, because I do think that this system – yeah, your last question – would it work on a national basis? Yeah, as a matter of fact, I think it would, but it might morph and evolve into something that would be a good bit nastier than it would – the extent to which Russia has contact with the outside world and the global economy and has to, at least to some extent, adapt itself to those rules, is a good thing and conversely, if they don’t have to worry about that at all, it could be really, really ugly.


Q: Thank you, John Evans, ex-State Department. There was one name that I kept expecting to hear during your brilliant presentation on this, and that was Alexei Kudrin’s. We all know that Vladimir Putin spent some time at the Gorny Institute, but he is hardly, really, an economist himself. And yet, Kudrin, at one turn and then the next, has been deeply involved in fashioning their policy, particularly their monetary policy. He was behind paying down the debt ahead of time and so on. So I’m just wondering if – I never did hear his name mentioned and I’m wondering to what extent he is really the hero and architect of this?

MS. GOTTEMOELLER: Thank you. Andrei Illarionov.

Q: Thank you. I became a little bit puzzled by your presentation and by your comments. On one hand, and especially in this discussion, you have said that Russia is rather similar to many other countries, including the United States, but on the other, especially in your main presentation, you have shown quite clearly that Russia is quite outstanding – quite not similar to others – especially in the so-called meltdown by fall in the stock market, by fall in exchange rate, by loss of foreign exchange reserves, by fall in industrial output, and we can continue this list of indicators.

So – and even in the stimulus package, in reality, before this last Obama package, the stimulus package in Russia is two-and-a-half times larger as a ratio of GDP than in the United States. So how would you explain this extraordinary size of this meltdown in Russia, compared to all other countries? And the other question, related to this, your model suggests that Russia’s or Putin’s model is oil addiction, but if you look on other oil-producing and oil-exporting countries – oil-addicted countries – you would not find such a situation in no other country, neither in the developed world nor in the developing world. All other oil-producing and exporting countries are doing much, much better. How would you explain this crucial difference between those countries?

MS. GOTTEMOELLER: Thank you very much. I will take one more question. Please identify yourself.

Q: Thank you. I am Alex Pimina (ph) from the Russia service of VOA, and my question is – I would like to go back to the question of the nature of private ownership in contemporary Russia and also to foreign political issues, because my concern is not the relationship between Putin or between the state, on the other hand, and the oligarchs on the other, but rather the question of the system of relations among the oligarchs, because I would like to recall the words by Oleg Deripaska who said that he would return his fortune on the first Putin’s demand.
And my question would be to what extent such a property could be qualified or characterized as private. So I think – and my second question would be, isn’t it actually the time to really rethink the very nature of the so-called private property in contemporary Russia, because I think that would be very important in the foreign political context, because having such an economic background, such a state would have completely different political interests. Thank you.

MS. GOTTEMOELLER: All right. Gentlemen?

MR. ICKES: Okay, regarding – it’s on. Regarding Kudrin, I guess that would be the simplest – I think he’s right at the center of the whole thing. Kudrin came to Moscow and then Putin came to Moscow. These guys have been together. He knows the rules; he’s part of the system, too. That’s the simplest – that would be the simplest point. I don’t know –

MR. : And he’s a smart guy.

MR. ICKES: Yeah, he’s a very smart guy. Regarding Andrei’s comment about – yeah, okay.

MR. GADDY: All right, well let me take that. No, Andrei, it’s not – the Russian meltdown is not extraordinary. The single one – you mentioned stock market, exchange rate, foreign exchange reserves, industrial output – on every one of those points, except for one, Russia is right in the middle of a bunch of countries, a bunch of Western European, highly developed countries have performed worse on those measures than Russia, a number have performed better, and the same thing goes with certain emerging and developing economies. So Russia’s kind of in the middle.

The stock market’s the only thing, and we tried to make the explanation for why that is – the bubble was bigger; therefore, you let more air out. That’s, you know, that’s what it is. The size of the stimulus package, I don’t think that’s true, but who knows maybe you’re right. But the point is, you can’t have it both ways. Andrei, if you’re against stimulus packages, then I guess having a big stimulus package is a bad thing, but there are a lot of people who think the bigger the stimulus package – that’s their concern, can we get a big enough one – then I guess that would be to Russia’s credit to have a big stimulus package.

Also, it was adopted early. Also, you didn’t have to submit it to a bunch of guys who discuss about it. You just, you know, announce it one day, which again, is part of the reason Putin would find he’s vindicated in this, you know. He announces one Monday that he’s got this giant bailout stimulus package and he observes across the ocean that we couldn’t get this thing – the TARP – through Congress. So those can have a different – be interpreted differently by Putin and us. Well, the difference between Russia and – maybe you wanted to say that.

MR. ICKES: Yeah, I mean, I was glad that you said the thing about why addiction only in Russia, because usually the argument comes back, well, everyone has this addiction problem, not just Russia. But if you’re – let’s take your premise as true – why is Russia different? Russia’s different because of the Soviet inheritance. Addiction started with this – and resource dependence – precisely because the price system didn’t reflect opportunity cost and non-transparency.

And the whole reason why addiction took place is because you couldn’t tell what were value-producing and non-value-producing sectors. Addiction behavior is a legacy from the Soviet regime and that’s where addiction first started. And that’s why Russia suffers from this problem different
from other oil-producing countries – they didn’t have a Soviet past. That would be the – I mean, that – we’ve got like three chapters in the book on that one. So I like that question.

MR. GADDY: And finally, the question about, you know, is this real private ownership we’re talking about if we take someone like Deripaska at his word that if Putin snaps his fingers, he’s prepared to give it all back. Well, you’re absolutely right. This is not, certainly, security of property rights that we would associate with true private ownership, and that’s the whole point of what we’ve been talking about, is these are contingent property rights – contingent on playing by the rules of the system that he lays down. And that’s why we wanted to try to lay this out.

It’s very important to understand that it is neither a Soviet system, with state control and state ownership, nor is it a traditional market economy or a, quote, “normal market economy”; it’s something that – I really think he thinks he came up with this, and maybe he did, but I think he thinks it’s the – you know, it’s the magic bullet, it’s the great solution – he’s the genius who came up with this. But it did reflect a good bit of serious thinking about the inherent tensions between the two. So, yeah, it’s right – this is not private ownership in the way we think about it.

MS. GOTTEMOELLER: Okay. Andrei Illarionov, I wanted to give you a brief right of reply if you’d like to take it. Any comment back? Microphone please.

Q: Just – this is just a note of data. The stimulus package in the U.S. before this last one was 5 percent of GDP – of the U.S. GDP – in Russia, initially, it was 12 percent of GDP – 12-and-a-half – so just a clear difference. In terms of industrial output declined, Russia is the hardest-hit country in the world with the exception of Ukraine. The adjusted annualize decline, including December, is 40 percent of GDP – 40 percent of the peak level. Only Ukraine hit harder – it’s about 55 percent.

There is no other country in the world comparable size did experience such a decline. In terms of some kind of – both facts, exchange rate and decline – together with loss of foreign exchange reserves, because it’s necessary to look together on these two indicators because in August, as has been mentioned, in August during the Georgian war – the Russian-Georgian war – the Russian central bank has spent a lot of foreign exchange reserves to preserve – prevent devaluation of our currency, and that is why it lost a lot of reserves. So just by these two factors, Russia is probably close to Iceland or some other countries, but Iceland is really small. Russia is big and Iceland does not have neither oil nor gas.

So just if you look across main indicators, Russia would be, really, outlier north of these indicators. And that is why it’s a really serious question why Russia has been hit so severely compared to all other countries, both oil and gas countries and non-oil and non-gas countries. And this is a question mark.

MS. GOTTEMOELLER: Okay, thank you very much. It sounds like a debate that is worth continuing over a longer period of time than we have today. We have 10 minutes left. I’d like to take a last series of questions. I saw Fritz Ermarth’s hand, Jack Brougher, so let’s take those two.

Q: Yes, my amateur reading of the current material indicates something of a policy debate between what you might call monetarists or fiscal – the main line from Putin – fiscal conservatives in dealing with the crisis, and modernizer developers who seem to be more affiliated with
Medvedev. This is something of a contemporary echo of discussions back during the solid years of the recent past, where some folks said, let’s use some of those reserves to actually address some social problems of this country: physical infrastructure, human infrastructure, military modernization and reform, diversification of the economy as well.

From listening to you it sounds like, A, Putin doesn’t really care about those things. You know, he wants to preserve the system; let the country go to hell and Medvedev doesn’t matter. And then when you say, you sign up to a kind of invest in the oil patch and development will trickle down or trickle out, that you’re almost affiliated with that, as a policy recommendation.

Could you respond to all that? I mean, particularly this matter of what appears to be a debate between, you know, Putin’s side of the discussion of how to manage this, which is the most powerful, and then there are these voices who call for social, economic development.


Q: I’m Jack Brougher from the Department of Commerce. It’s been very strongly emphasized that maintaining financial independence is a basic tenet of Putin’s policy. Will this not limit in a very practical way, a role for Russia in resolving the international financial crisis and participating in any reform of the international financial system? And, secondly, how strong a desire to play such a role is there in Putin or other members of the government?

MS. GOTTEMOELLER: Thank you. And the last question goes to Chas Freeman. No, no, okay, do we have one more question in that case, anyone else? Yes, please wait for the microphone, please – here it comes – and please do identify yourself.

Q: Merryl Burpoe, Department of Energy. We’ve been looking at Gazprom and its economic situation. I’m curious as to whether you think its defaults are so significant that Russia will have to step in to an extent that they will want the rest of the ownership of Gazprom in return.

MS. GOTTEMOELLER: Okay, thank you. (Chuckles.) Good questions. Well, gentlemen, this is your chance not only to answer these particular points but also to wrap up with any final comments.

MR. ICKES: Fritz, basically your question is: what to do with the reserves. And, you know, you outline this opposition but you have to think about it. I mean, this idea – let's spend some of these earnings solving – let's spend some of these earnings solving some of these other problems – is based on a belief or expectations that these reserves are going to keep flowing, right. If this stuff is – so partly this debate is because Putin’s fear that oil prices could come down because the ’80s experience was a big boom in rents and then a decline in rents – decline in rents, collapse of the Soviet Union. That’s why this conservatism went up there. So I guess if you want to characterize that we say Putin has the upper hand, yes, that part’s true.

With regard to the diversification issue, I mean, I really think – Cliff sort of was mentioning this at the end – it’s really the case that you can build up a successful economy by developing those skills that are associated with resource economy. You know, when oil was discovered in Southern California, there were more petroleum engineers in Southern California than in the rest of the world combined. Stanford, University of California Berkeley, USC, they developed the first petroleum
engineering things in the world. Those industries then led to more oil discoveries; the whole Oklahoma oil discovery was because of that, and then you build all these other technical things. Russia could become – use its human, you know, its scientific potential and its human capital to be the greatest energy-lifting thing, but because you really need those resources – if you want to solve any of these other problems you need more rents.

Russia has to make sure it can keep the oil flowing, especially if this low regime takes place. And that means, dealing somehow with East Siberia and that really means taking some risks. And the way we see it is if you’re going to take the risks to develop East Siberia, you better tighten the protection racket on the other end because otherwise the system might fall apart, and that’s the thing Putin wants the least, because he wants to be in the saddle. Okay, I’ll leave that to – (inaudible). I’ll leave the hard questions.

MR. GADDY: No, the question about the tension or the contradiction between a desire for financial autonomy, on the one hand, or autonomy of, you know, political autonomy, any kind of autonomy – and participation in multilateral global institutions – the very concept of which is sacrificing some of your independence and autonomy – that’s really important for Russia, certainly important for Putin if our version of his thinking is anywhere close to true, because he will have to then start to make these trade-offs, and this will be another way in which he’s going to have to figure out which has the highest priority.

My feeling is that he will try to figure out ways to always have that ultimate insurance, always have that ultimate sense that there’s some way we can – in the worst-case scenario – we will be able to shape our own destiny and the financial autonomy part is pretty clear cut right now: Can there be some other form of this? So that’s an important issue, I think, to keep in mind to the extent to which Western countries, ours and others, want to engage Russia and bring it in to true international cooperation, the G-20 or whatever. I think that being aware simply of this Russian priority is extremely important.

And, yeah, on the Gazprom question, well, I mean, I’m not going to venture to say what prediction or whatever but I just take it as a given that if they have to bail anybody out they’re going to end up taking ownership in return. Well, we have done the same and we will continue to do the same in other countries as well. So, yeah, it may end up – and undoubtedly will end up – it already is on the trend that there’ll be more state ownership of the Russian economy as a result of this crisis. Whether that stays that way necessarily, I don’t know.

MS. GOTTEMOELLER: All right, well, thank you very much to our presenters and also to Mark Medish. I have just spoken to Cliff; if you are interested in getting a copy of their slides we will work to get a copy of the slides up on the Web site in the next day and so if you’re interested it will be available. And I wanted to thank you, the audience: great questions, great discussion. And, again, let us all join in thanking our presenters.

(Applause.)

(END)