

# **“Putin’s System in a Regime of Low Oil Prices”**

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Best source on all this:

[http://www.brookings.edu/articles/2009/01\\_putin\\_gaddy.aspx](http://www.brookings.edu/articles/2009/01_putin_gaddy.aspx)  
[ickmansblog.blogspot.com](http://ickmansblog.blogspot.com)

# Introduction

- We will focus on economic policy
  - Putin's policy
  - He is unchallenged CEO of “Russia, Inc.”
- “Putin's System”
  - The set of policies, priorities, and instruments to realize the policies.
- Primary focus not economy in itself, financial or “real”
  - Focus is the system and robustness

# Introduction

- How well has Putin's system performed so far?
- Will – can – the system continue?
  - In other words, is it robust to this crisis?
- Can it be adapted, or will it have to be rejected and replaced?

# Putin's System: Key Premises

1. The economy is the key for Russia's strength in the world.
2. The economy should be as strong and efficient as possible.
3. The economy should ensure priority of state interests.
4. The economy must be robust to crisis.

# Priority 1: Efficiency

1. A Soviet-style economy (central planning, state ownership) will NOT be strong and efficient, only weak and inefficient.
2. Therefore: Russia needs a market economy with private owners.

## Priority 2: State's Interests Paramount

1. Dilemma: Since Russian wealth concentrated in few industries, private owners with full property rights would end up owning the state.
2. Approach: State leaders must somehow control private owners without blocking their efficiency.
3. Solution: “Property Rights Protection Racket”: Allows to exploit efficiency of market while maintaining control

## Priority 3: Robust to Crisis

1. Matter of life-and-death
2. Cannot permit repeat of 1980s, 1990s.
3. Read Gaidar's book.

Subtitle: "Lessons for Today's Russia"

4. Solution: Pay down debt, build up reserves.
5. Believed only he found answer.

He crows about it.

# Putin's Pride

- “The **American, European, and British** structures were ... **all caught off guard ... All these institutions** turned out to have been **caught off guard** ... Even such structures as **the ratings agencies, the Basel Committee, and the IMF** demonstrated how **unprepared** they were for the crisis.”
  - [Russia has not escaped the effects of the crisis.]
- “But above all, I’d like to say that **we did not allow ourselves to be caught by surprise**. When we formulated our long-term economic and financial policy, **we took into account potential risks and threats**. We were sometimes even **criticized for excessive conservatism**. And yet I think that **conservatism proved justified**.”

-- Prime Minister Vladimir Putin, October 20, 2008



# Protection Racket

- Point of a protection racket is that the guy offering you the protection is the one who represents the threat that you need to protect against.
  - The property rights are what are under threat, and the one who threatens them is the one who is asking for the payoff.
- Why not just formal taxes?
  - much more control over how it is spent
  - also creates addiction

# “The Deal”

- Keep property
- Make companies more productive
- Get richer
- Be protected against expropriation – or worse!
- Pay taxes – in cash, in full
  - Don’t try to change tax laws
  - Don’t collude with governors
- Share wealth informally
  - “Excess costs”
  - Philanthropy
- Let Putin make strategic decisions (esp. foreign)

# Protection Racket

- Protection racket necessarily limited to rent-producing sectors
- Intentionally not widened, Why?
  - Lack of attention span
  - Lack of rent in other sectors => low payoff
- Rule of law is anathema to protection racket

# Look at Putin's Model in Three Phases.

- **PHASE I: 2000-2004**  
(oil @ \$32)
- **PHASE II: 2005-2007**  
(oil @ \$62)
  - **PHASE IIa: first half of 2008**  
(oil @ \$107)
- **PHASE III: August 2008-?**

## PHASE 1 (2000-2004)

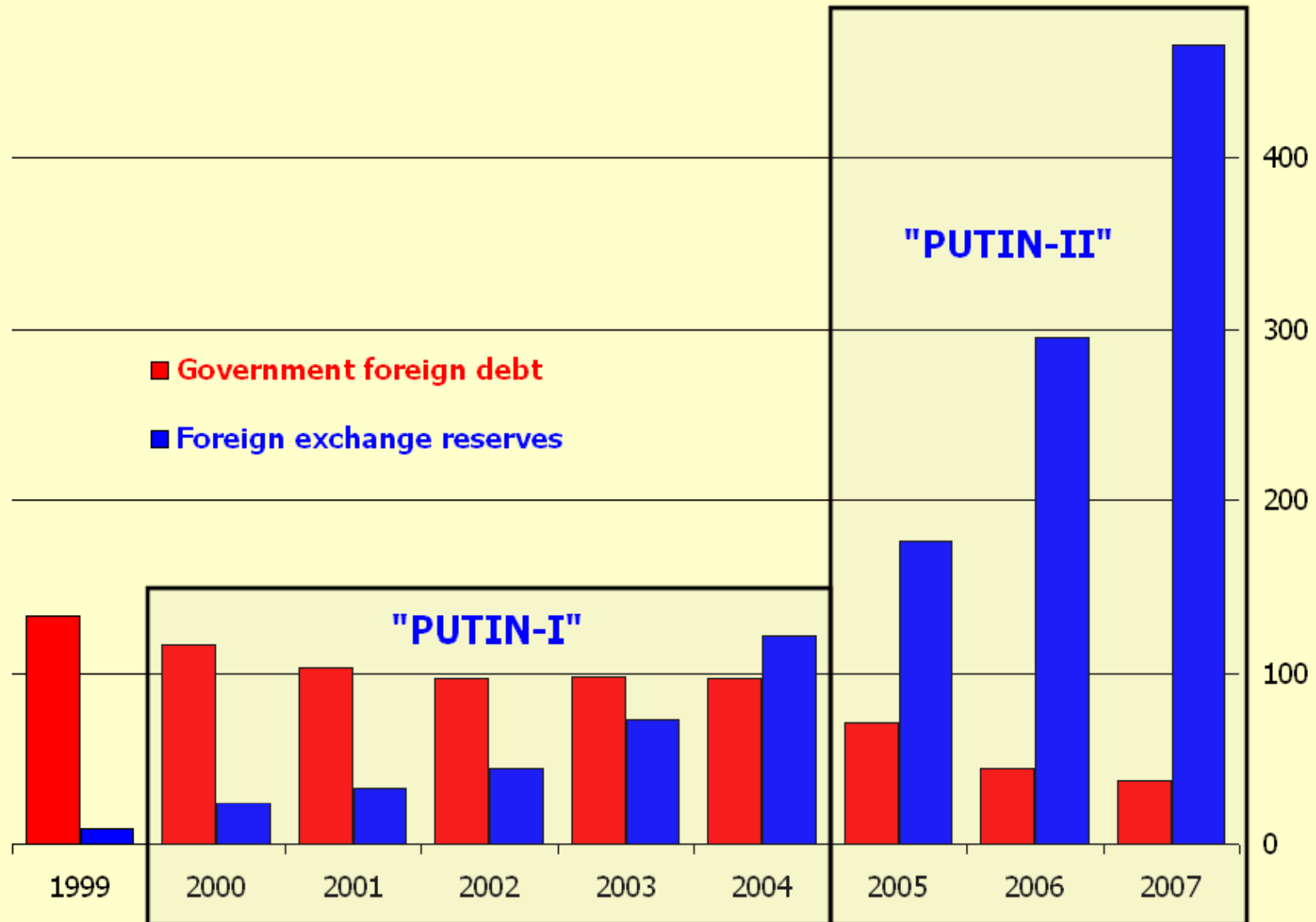
Average oil price = \$32/barrel

Simple priorities:

- (1) Establish control of oligarchs
  - Property Rights Protection Racket
  - Tax reform
- (2) Achieve financial independence by paying off debt.

# Achieving Independence

USD billions  
at year end

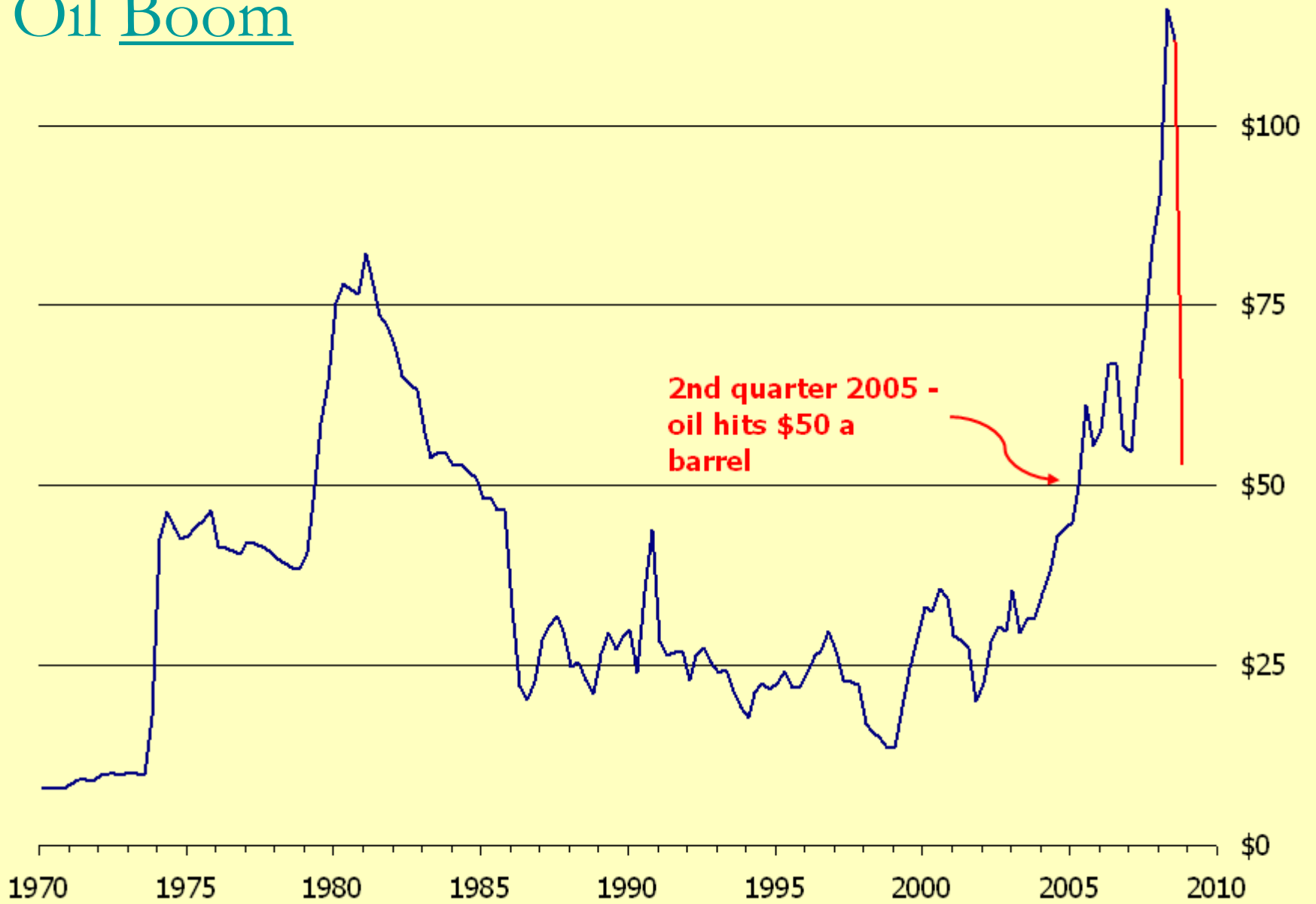


## PHASE 2 (2005-2007)

Average oil price = \$62/barrel

- Main event: Oil windfall.
- Turning point: mid-2005, exceeds \$50/barrel.
- Continue to pay off debt (IMF 3 years early, Paris Club)
- As windfall grows, 3 policies:
  - (1) Continue to tax away windfall
    - In 2005 – 2006 - 2007 put in more than 40% of GROSS oil export revenues into Stabilization Fund
  - (2) Restrain physical output of oil
    - No reason to expand, since price rise already producing more rent than can handle easily
    - Don't risk more addiction
    - Don't expose to price fall risk
  - (3) Move to offshore financial intermediation
    - Domestic financial system cannot handle – inefficient
    - Result: Private debt grows as much as export revenues

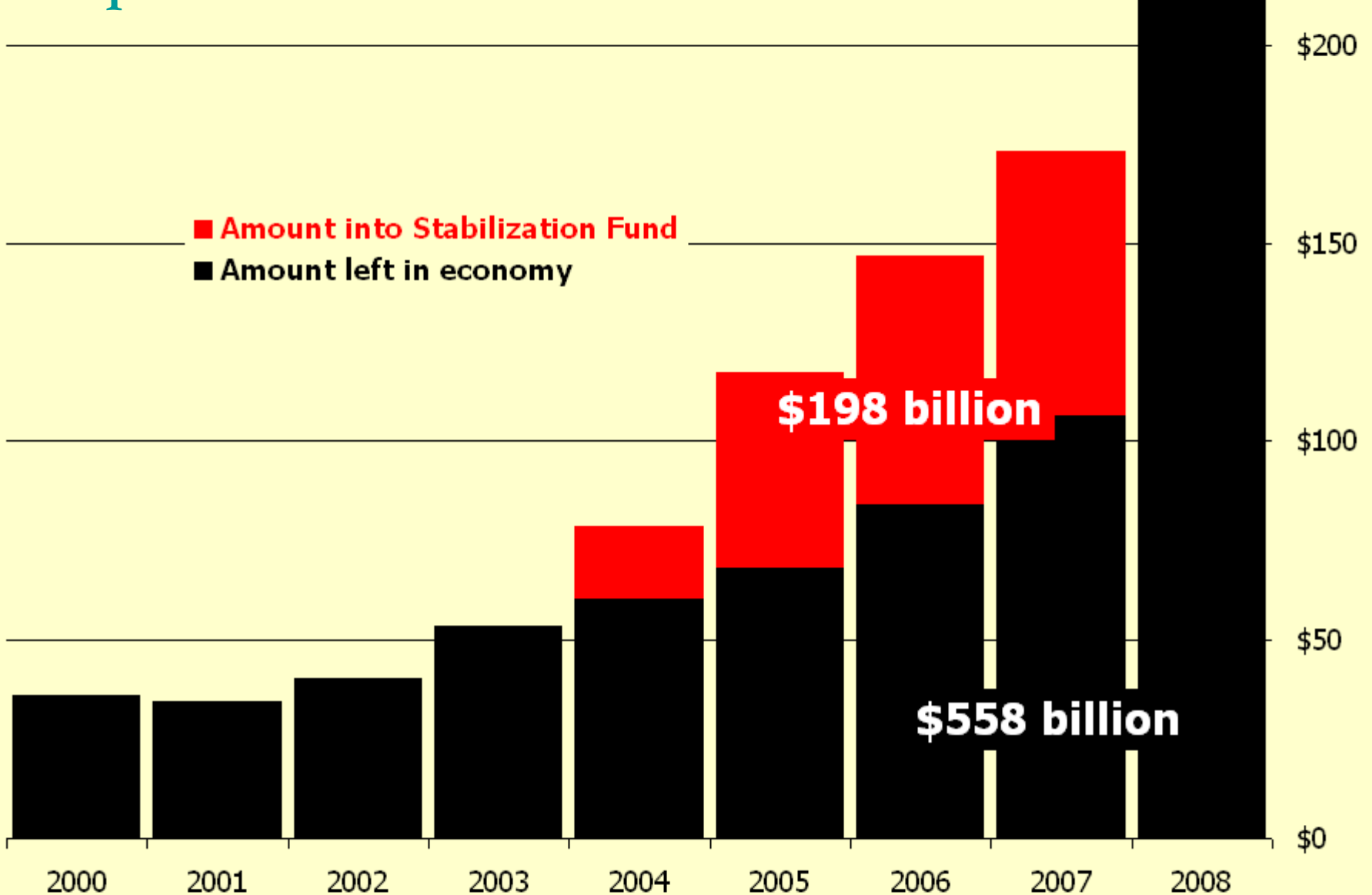
# Oil Boom





# Stabilization Fund Share of Gross Oil Export Revenues

USD bns



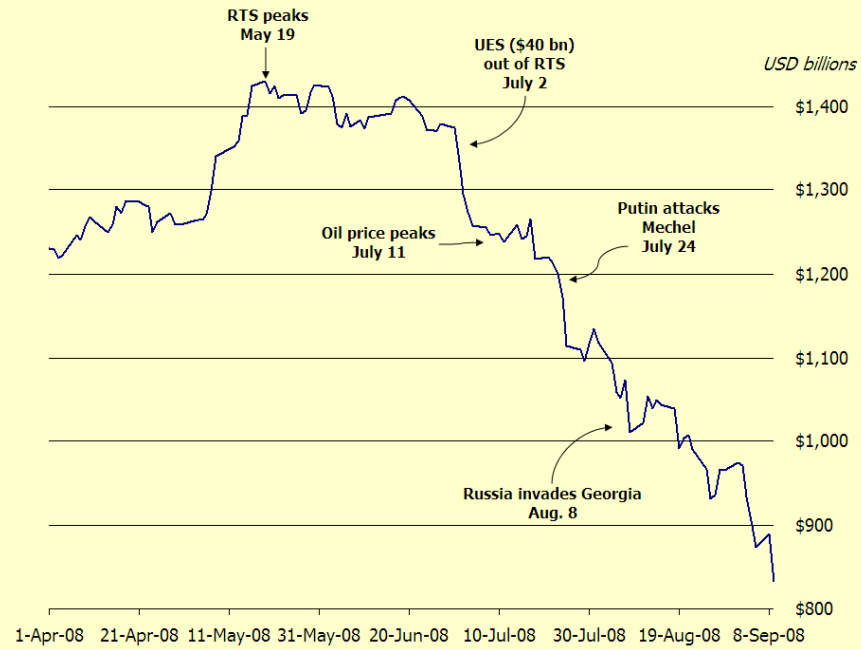
# Financial Fragility

- How to deal with export surpluses?
- Recycling via private debt (MacFarquar thesis)
  - Similar to New Bretton Woods in Asia
    - => thin financial system based on capital inflows
  - Because financial market was thin, oil price had bigger bubble impact in Russia
    - => fragility when international financial crisis arises
- Note: This was an example of Russia engaging with the West, opposite of autarkic reaction
  - Optimal risk sharing

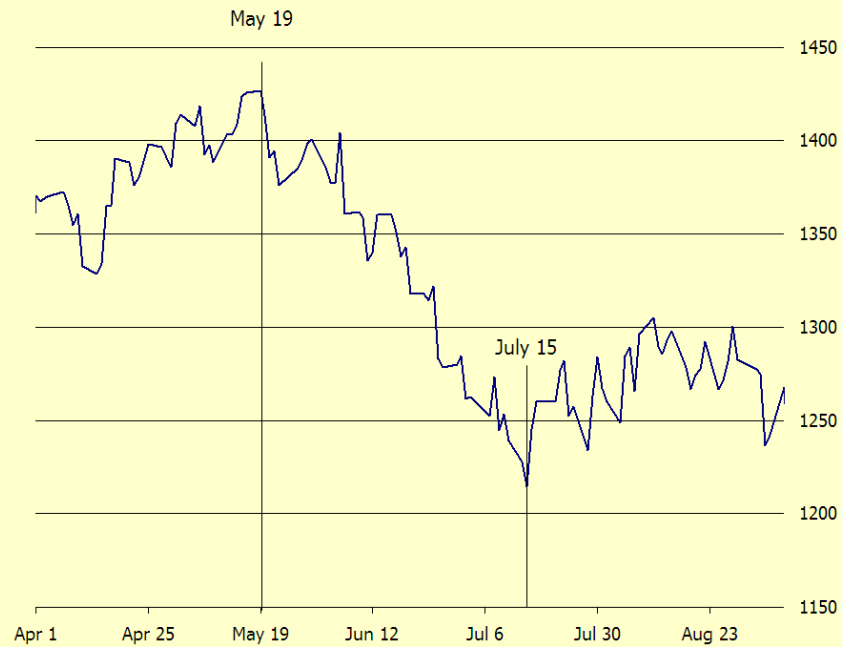
## PHASE 2a (first half of 2008).

- All this looked quite successful into 2008. And better than others:
  - May 2008, US and other stock markets start collapse.
- Russian market buoyed by continued rise in oil price
  - Putin et al. declare Russia a “safe haven”
- This is PHASE IIa – very brief
  - BUBBLE mentality prevails.
- Stop accumulating in Stabilization Fund just as oil hits historical highs!
- PHASE III is now – collapse of oil price.

# RTS



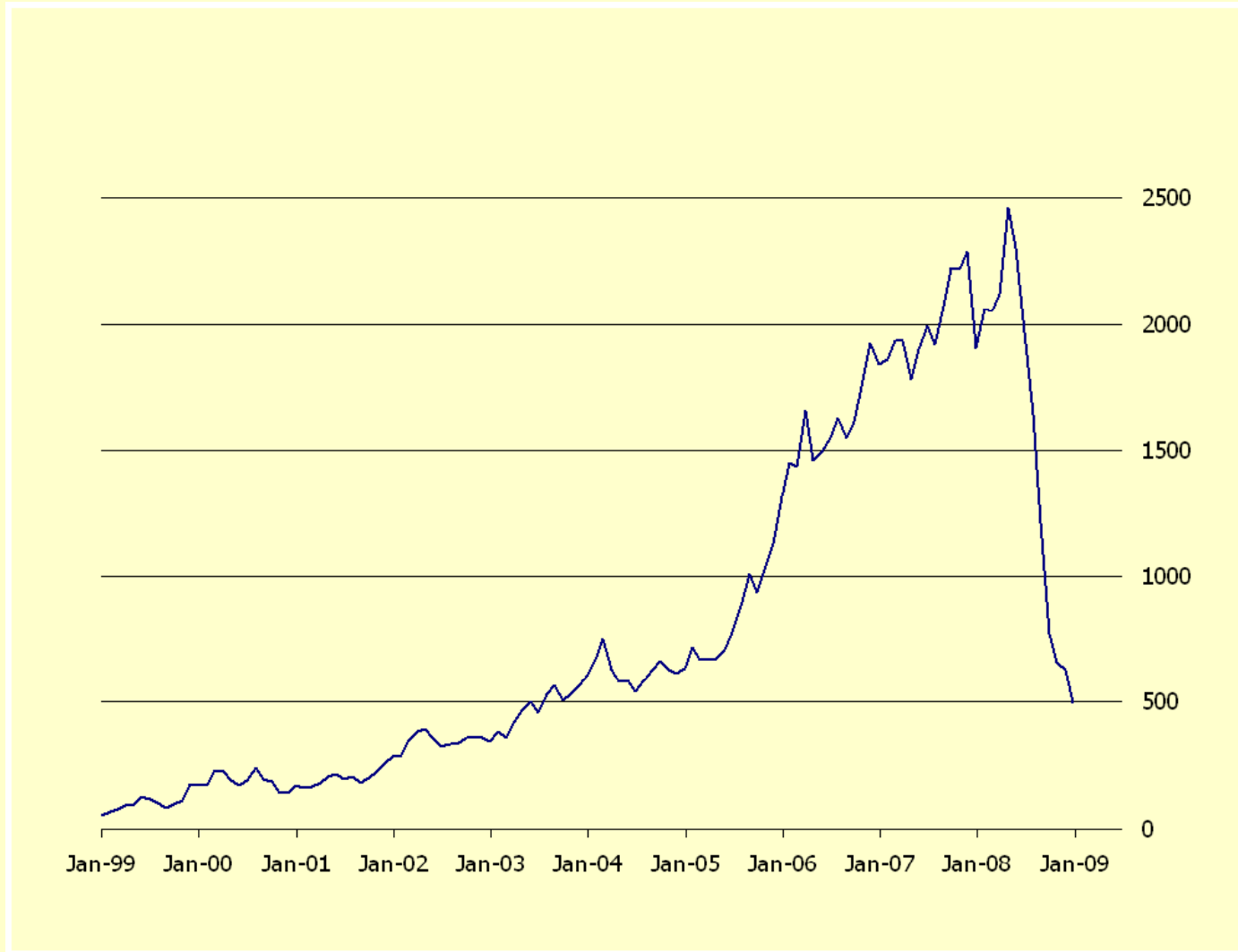
# S&P 500



# Putin Succumbs

- Putin long protected against bubble
  - He read Gaidar's book
- By Feb 08 he succumbs to bubble mentality
  - He bragged rather than warned about
    - “Russian stock market increased in value by 22 times since 1999.”
- Once prices reached \$120, he perhaps assumed they could not fall below \$90
  - Hard then to get anyone to believe it could happen

# RTS Index, 1999 thru 2009



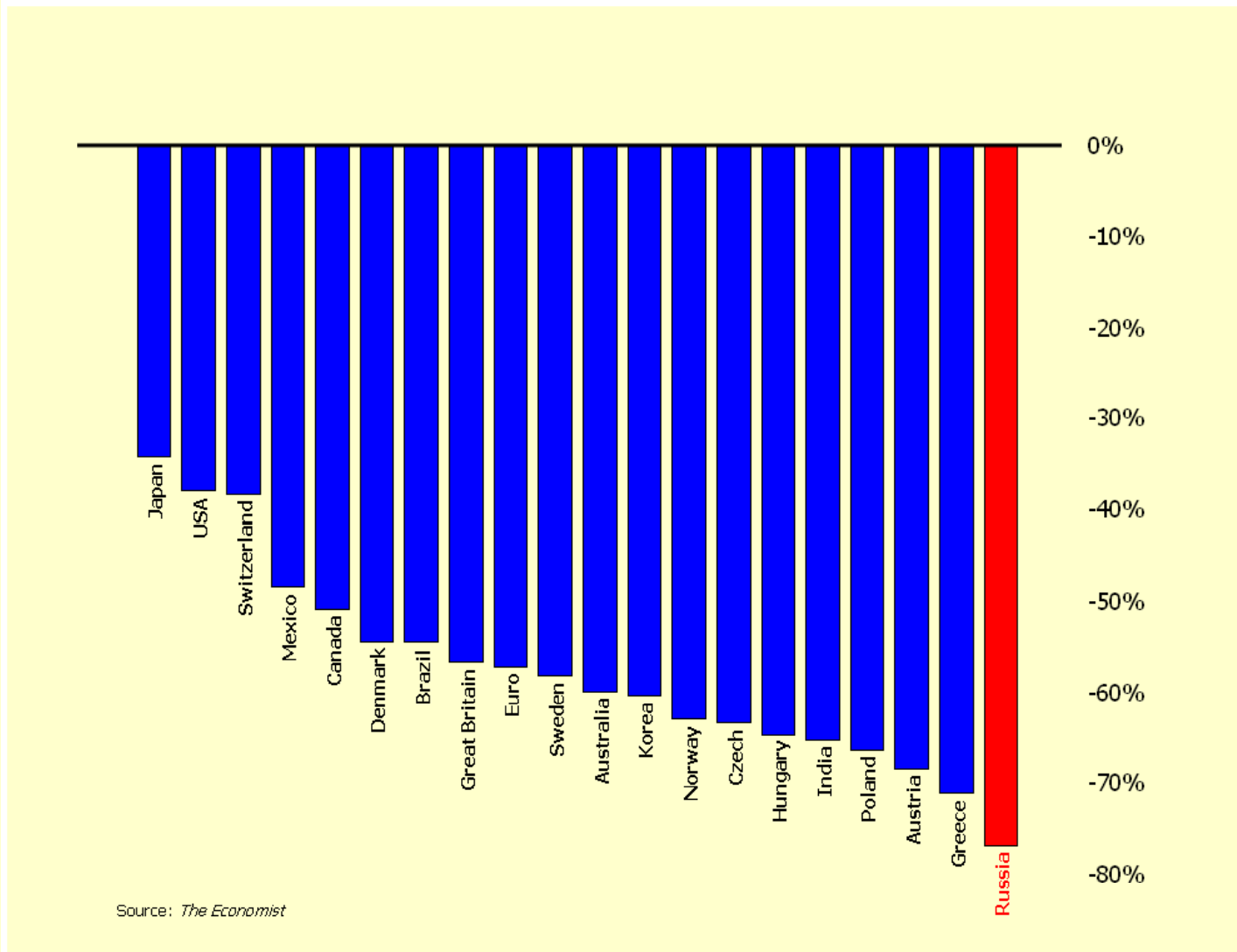
Gaddy-Ickes, CSIS Presentation,  
October 20, 2008

# Bubble Bursts

- Russian stock collapse is the biggest
- If pre-August 2008 was a bubble, then its collapse is not a sign of poor performance
  - Rather result of interdependence
  - RTS is now at Fall 2003 level
  - Russian market fell more because bubble was bigger

# Selected Global Stock Indexes

% Change Dec 31 2007 thru Jan 21, 2009

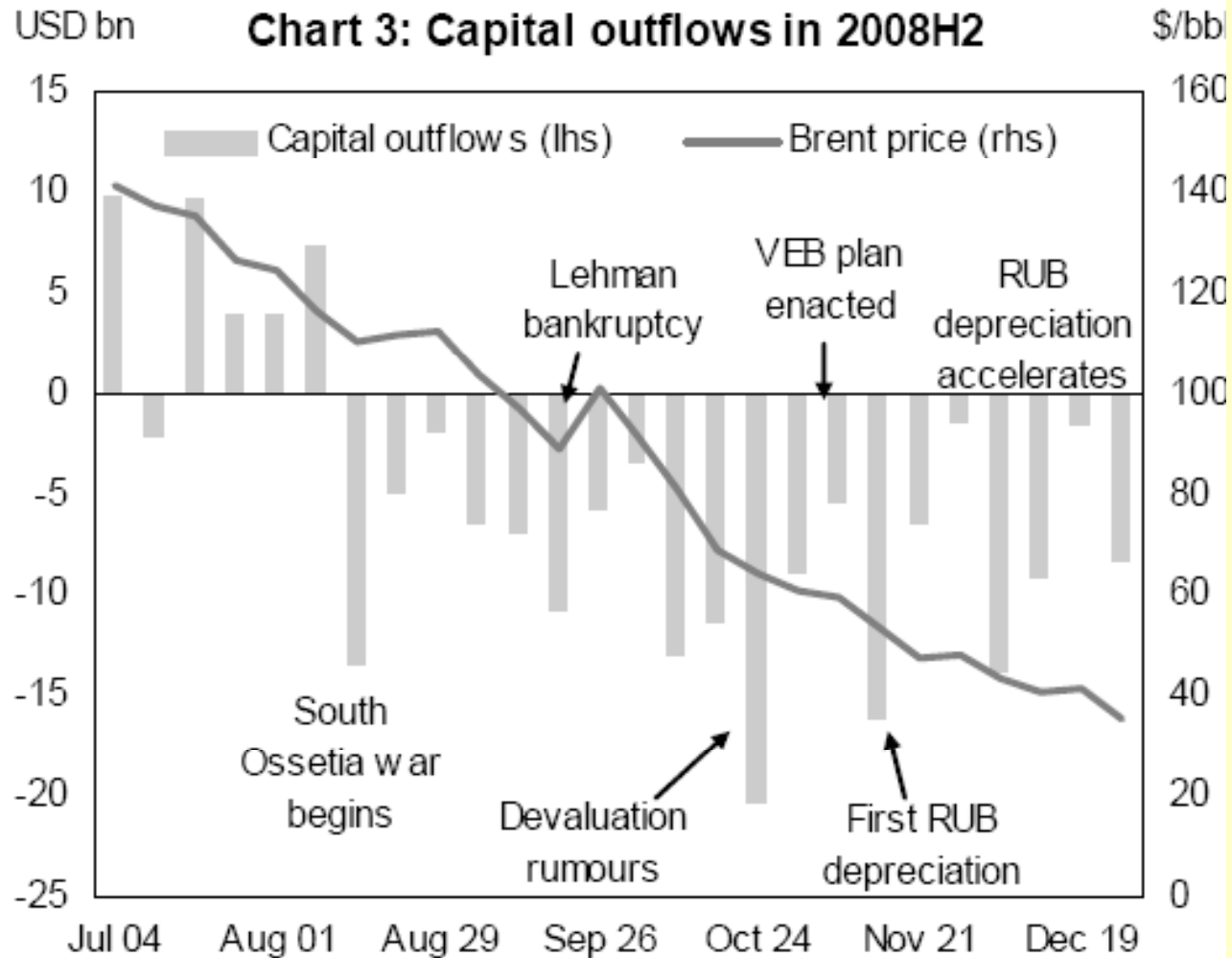




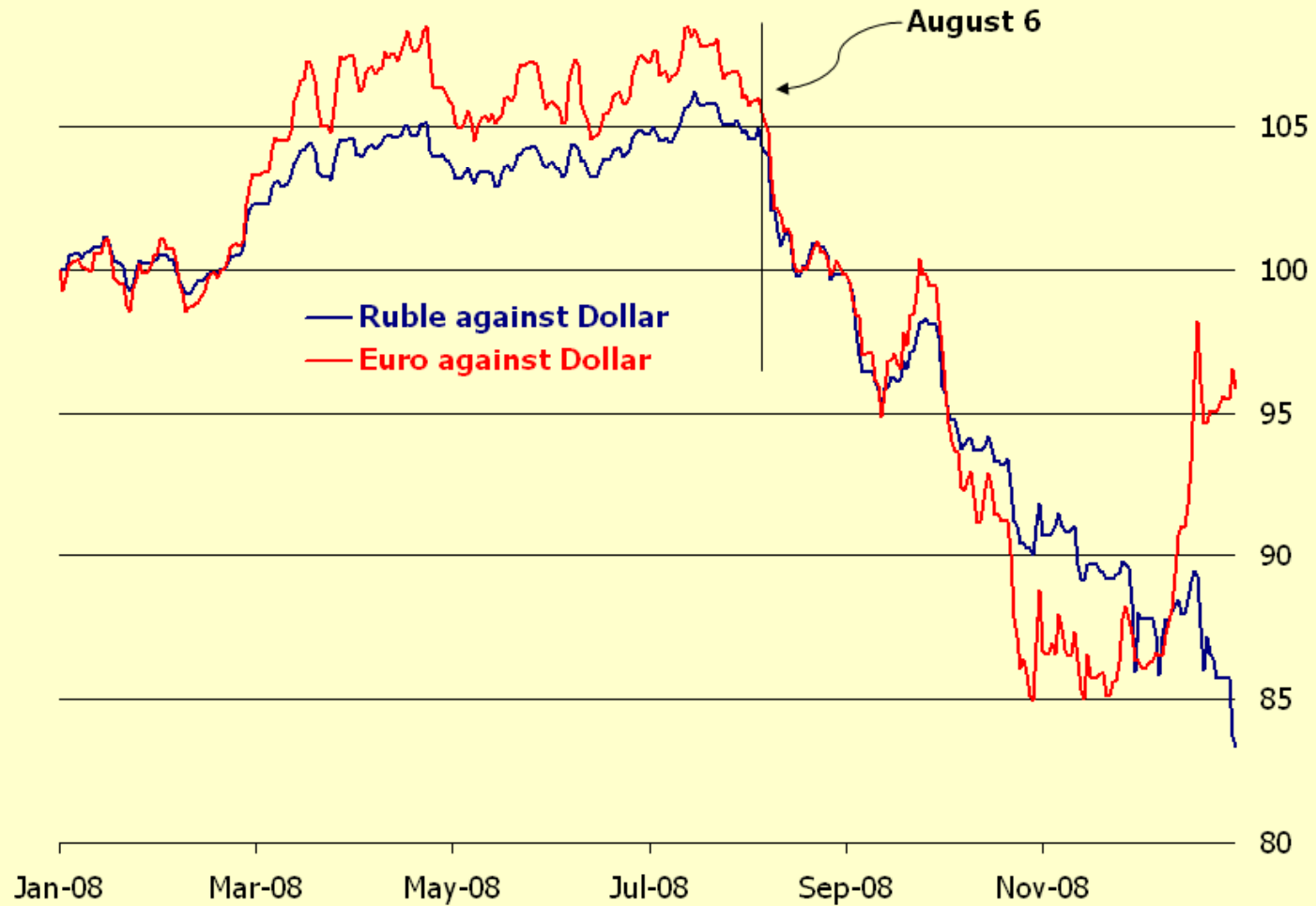
# Crisis

- If you look only at Russia it appears that the crisis is due to Georgia War
- But this ignores the international crisis
  - The dollar begins to appreciate against the Euro at the same moment
- Russia was bystander to international financial crisis
  - Precisely because it integrated financially with West
  - International financial crisis causes oil collapse, feeding back to Russia

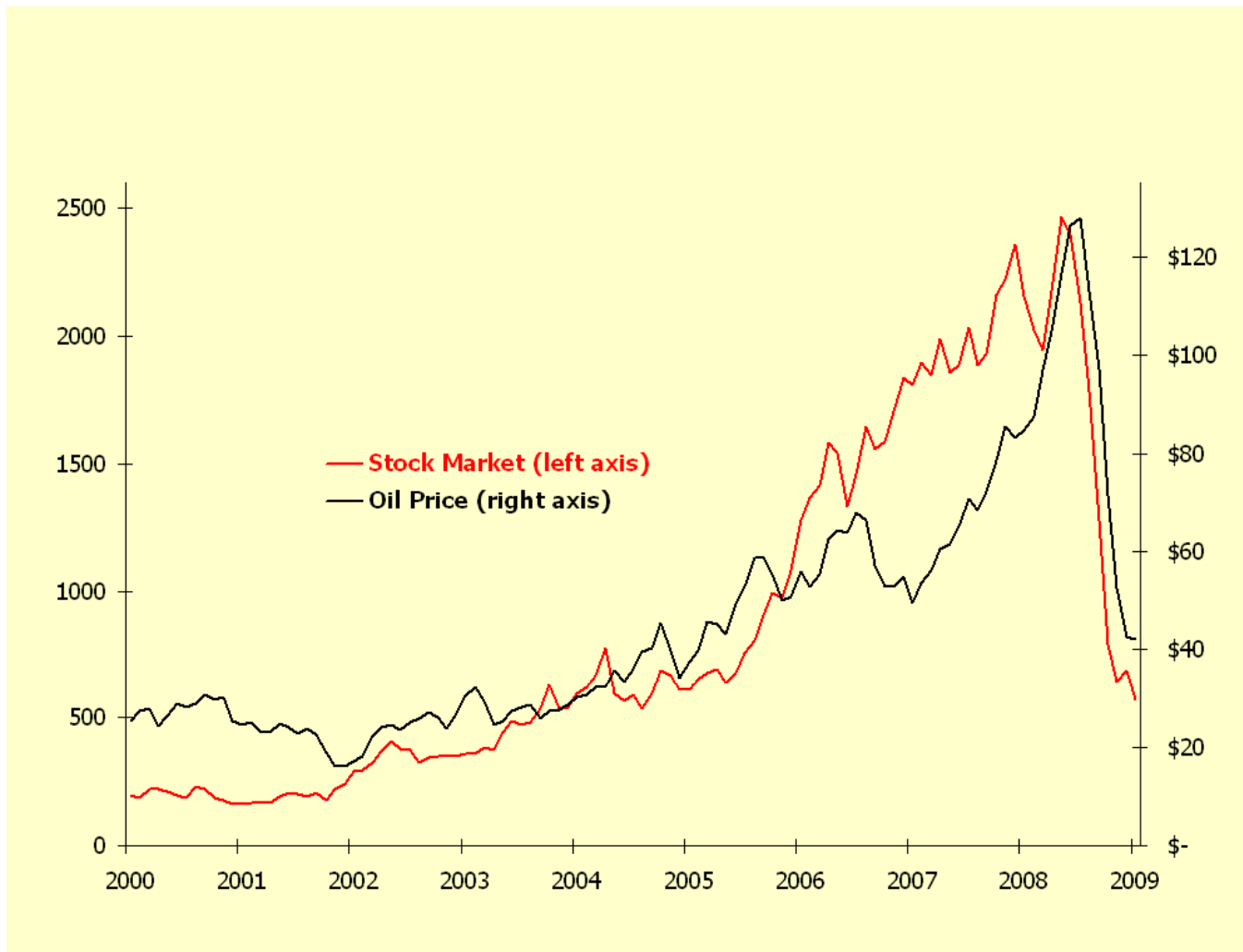
# Capital Outflows in 2008: H2



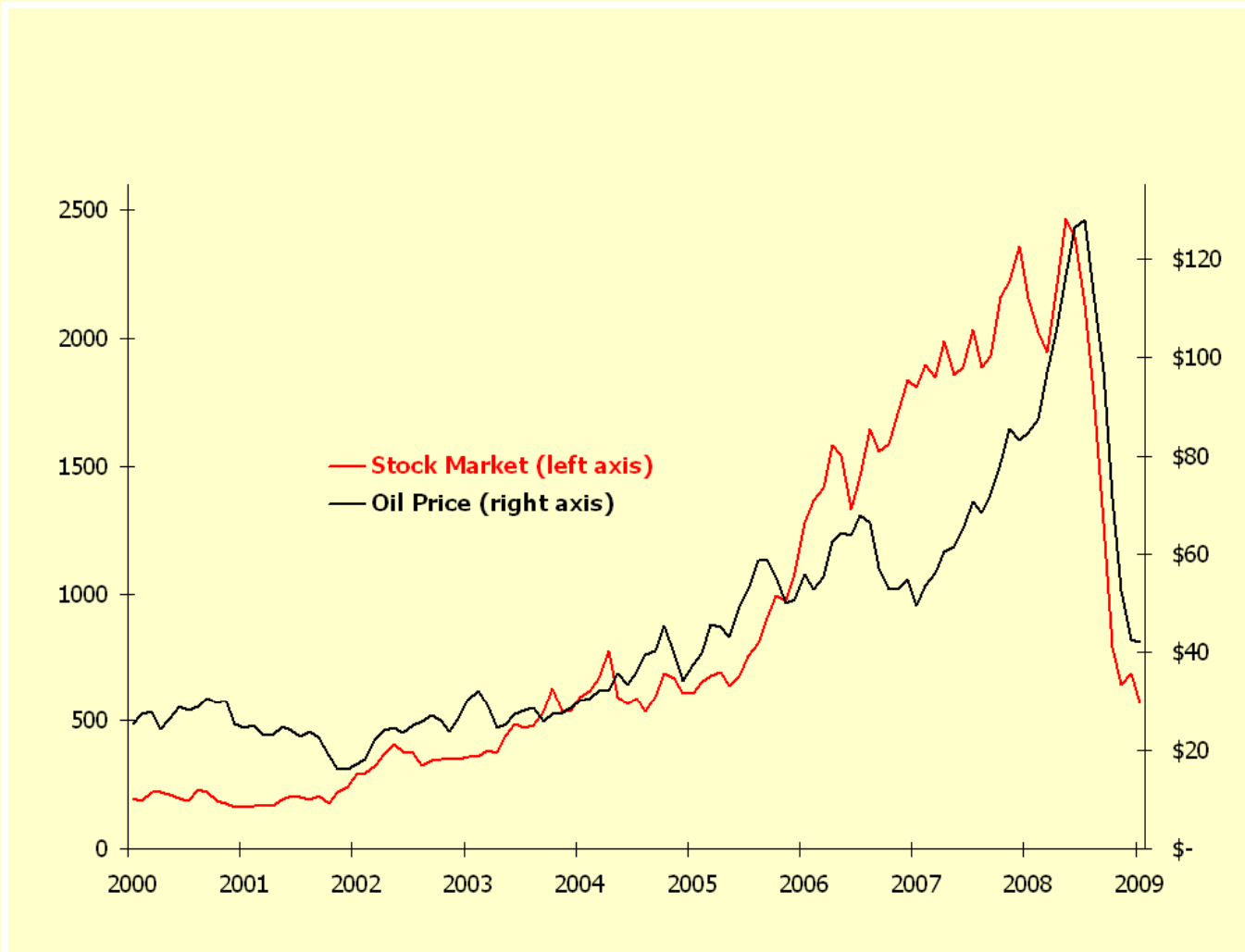
# Ruble and Euro Against the Dollar



# RTS and the Price of Oil, 2000 - 2008



# RTS and the Price of Oil, 2000 to 2008



# Putin and the Ruble

- Gradual devaluation led to loss of reserves. Why did Putin allow this?
  - Fear of inflation
  - Time for public to adjust
  - Protect the oligarchs
    - Notice that Putin could have allowed them to default and taken their assets
      - => destroy the protection racket
    - He did the opposite
    - Preserve the system and maintain his power

# The New Price Regime

- Everything depends on where oil price goes
- Key medium-term challenge for Russia is NOT “diversification away from oil”; rather how to *ensure future of oil production*.
  - How to insure the production of rents; more pressing with low oil prices
  - Back to reality
- Dilemma: How to share the risk of Eastern Siberia w/o damaging his system

## 2 Points

- Putin's system worked for 8 years, he feels vindicated
  - Worked well in the crisis
- This does not mean it will work in the new price regime
  - Mainly because of the East Siberian challenge



# Liberalization

- We could see some liberalization regarding oil companies
  - Shift away from control towards efficiency
- But this will not be general liberalization
  - Likely the opposite
  - The protection racket will be tightened to maintain the system

# The End

- To be figured out during 2009