

Meeting Summary

Russian Debates about How to Allocate the New Wealth

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Presenter: **Clifford Gaddy**, Senior Fellow, Foreign Policy, Global Economy and Development, Brookings Institution

Barry Ickes, Professor of Economics, Pennsylvania State University

Chair: **Andrew Kuchins**, Senior Fellow and Director, Russia and Eurasia Program, CSIS

Rapporteur: **Samuel Charap**, Visiting Fellow, Russia and Eurasia Program, CSIS

This was the fifth of six meetings in the series, “Economic Change in Russia and its Implications for U.S. Policy,” a CSIS project sponsored by the Carnegie Corporation of New York.

The presentation given by Gaddy and Ickes would have been very different were it to have occurred a few months earlier. Then, Russia not only had a large stock of wealth in the form of currency reserves and the Stabilization Fund, but the flows of wealth into the economy were large and growing. At the time of this writing, the main Russian stock index has lost over three-quarters of its value since its peak in May. Its reserves, now being used to implement anti-crisis policies and defend the ruble, have shrunk significantly. However, the fact that the global financial crisis has affected Russia’s wealth makes the question of how to allocate it all the more important. More important as well becomes the question of how to produce new flows of wealth (i.e. rents).

Gaddy and Ickes prefaced their presentation with their interpretation of the current crisis in Russia. The conventional wisdom points to the declines in the foreign exchange reserves, the exchange rate and the stock market as indicators of the effects of the crisis on Russia. In fact, the negative impact on Russia, while clearly present, is relatively typical on all three scales: most countries have lost value in their reserves due to shifts in exchange rates; most currencies, including the Swedish krona and the British pound, are down against the dollar; and most emerging markets have seen large drops in stock capitalization. Gaddy and Ickes argue that there is no evidence that shock from the August war in Georgia had any

impact on these measures. Instead the impact of the drop in the oil price, which is now less than half of its \$140 high earlier this year, has been the dominant factor.

Indeed, the main question regarding Russia's future growth and its wealth is the oil price and its impact on rent flows. All other questions are secondary, according to Gaddy and Ickes. The unpredictability of the oil price presents a key problem for Russian economic policy-makers. Forecasts about the future of the oil price are inevitably wrong, as demonstrated by Gazprom president Aleksei Miller's \$250 per barrel prediction earlier this year. Under such a situation of uncertainty, how do the Russians engage in strategic planning? In short, it is hard to exaggerate the impact of the future of the oil price.

Talk of broad economic diversification is largely a pipe dream; trying to achieve it could prove disastrous for Russia in the long term and in the short term simply raise levels of rent-seeking. Instead, the main issue is investing in oil production and bringing new reserves on line. Currently Russia has not adequately invested in the oil sector to provide for future growth in production. The problem is how to induce the necessary massive investments in greenfield projects, especially Eastern Siberia. Russia has to make high non-marginal investments with massive sunk costs to look for new oil and gas. However, since no one knows the future price of oil, any such investment is risky. At the current price level, if Russia invests now and prices go down to, say \$26, then the country will take significant losses. Eastern Siberian fields are estimated to be profitable only if the oil price is above \$70/barrel. This risk explains much of Russia's reluctance to invest. As a result, Russia has already fallen behind on the levels of investment necessary to maintain production output.

Here the factor of *real*, non-rent seeking diversification comes in. First, Russia needs to invest its surpluses outside of Russia as a way to maintain income. If Russia invests all its wealth internally and thus is completely dependent on the oil price, it cannot diversify its

income risk or consumption risk. External investment reduces dependence on the oil price. Second, Russia also needs diversification in investment in greenfield projects; it needs to share the price risk with foreign investors. If foreign investors come in, then they share the risk when prices go down. Why has this not happened? The government might be afraid that foreign companies want to play by formal, as opposed to the informal rules that dominate Russia's political economy at the moment. Or the government might be afraid that if it relies on the West then some of its freedom of maneuver in foreign policy will be limited.

To get around these problems, one solution is to open up foreign investments in both directions, which in fact is advantageous for all sides. In order to get Russia to accept Western foreign investment in Eastern Siberia, the West must allow Russian investment in Europe. This would develop trust internationally.