

March Madness: The Emperor Has No Clothes

Written by Editor
Tuesday, 08 April 2014 00:00

For many Americans and foreign alumni who've passed through the American university system, the month of March is known as March Madness. It is a month that basketball fans are glued to their televisions following the college basketball championship round-robin.

Elsewhere around the world March Madness in 2014 took on a much more sinister character. Russia's take-over of Crimea is only the latest in a long series of bullying incursions that the world's largest country has taken over smaller regional ones. Abkhazia in Georgia and Transnistria in Moldova jump to mind as the manifestation of Russian mingling in the affairs of states under former Soviet and now Russian influence.

In the past disputes between Russian nationalists, lead by Prime Minister Vladimir Putin, and its Ukrainian neighbor have been obscured through the fish-eyed lens of energy issues where Russia's displeasure of Ukrainian independence was blurred and marginalized along the lens' convex periphery allowing energy disputes to dominate the main field of vision. Russia's march into Crimea has dispelled this vision once and for all. The Russian President aka Emperor has been portrayed in the past as a shirtless fly-fisherman the image of which is presumably to his liking. This time Vladimir may lose his pants, and if he is not careful he and his country will lose their shorts, and will be left standing before the international community as a naked and brazen symbol of brutality.

Energy in Ukraine

Ukraine's geographic position and proximity to Russia explain its importance as a natural gas and petroleum liquids transit country both for Russia as well as for Ukraine's downstream neighbors across Europe. The configuration of Ukraine's pipeline infrastructure and its dependence on the Russian Federation for the majority of gas that traverses the country east to west (and the gas it consumes domestically) is attributable to its legacy as part of the former Soviet Union's pipeline network. Since Ukraine's Orange Revolution in 2004 and the election of Ukrainian President Viktor Yushchenko (who was poisoned incidentally during the election campaign) over his Russian-backed opponent (the recently ousted Ukrainian President Viktor Yanukovich) the price the Ukraine has paid for its gas has been proportionally higher than the more distant Germany pays for its own Russian gas (the Baltic nations are in largely the same unenviable position as Ukraine).

While a subsidy agreement had been struck by Russian backed Yanukovich that gave temporary reprieve to the troubled Ukrainian economy, on April 1st (and this is no April fool's joke) Russia's Gazprom again jacked up prices by 40% to some \$385 per thousand cubic

March Madness: The Emperor Has No Clothes

Written by Editor
Tuesday, 08 April 2014 00:00

meters. In deference to an EU loan bailout package of some \$27 billion and to a pending loan package from the IMF, the Ukrainian government has stated it will increase by 50% the cost of gas to its residential consumers. Presumably Gazprom will be pleased with a portion of the EU loan proceeds that will go towards retiring what it claims is \$1.7 in arrears for 2013 gas deliveries. It sees such arm twisting as righteous and effective in further economically destabilizing a Ukraine it supposedly longs after. By weakening the Ukraine economically through the energy subterfuge, Putin & Co. hope to maximize their influence over those in the Ukrainian public who find or feel themselves disenfranchised and who long for the good ole-bad ole days.

To be realistic there is very little in the short term that Ukraine can do to break away from dependence on Russian gas. In fact, the Ukraine has been trying to buy cheaper gas on the European market which raised the ire of Russian gas lobbyists in Brussels but due to a lack of west-east pipeline capacity there simply isn't enough throughput capacity to supplant Russian gas deliveries today. Regardless, the bottom line in Ukraine-Russia relations is that the legacy and current disputes in this bilateral relationship are not energy driven. This is about a revengeful Russian power grab.

The Emperor has no clothes

For years Vladimir Putin's Russia has put on a dog-and-pony show to depict itself as a modern state worthy of equal treatment and respect by countries of a greater economic or military magnitude than itself. Russia's procession of kennel-events from its hosting a G-8 summit back in 2006 to the 2014 Sochi Winter Olympics has been window-dressing for a state swimming upstream to create a stable middle-class against the flow of its own internal corruption. What Putin has put to the test is the loyalty of Russia's own middle class to continue to support him as Western sanctions begin to bite. On top of this is the fact that the Russian banana-republic's economy, as dependent as ever on its oil and gas commodity exports for funding its national budget, its military build-up (which led to the departure of the respected Russian Finance Minister Alexander Kudrin back in 2011) and its corrupt kleptocracy has a weakening economic base to pillar-on.

The Russian economy was barely growing before the imposition of sanctions (1.3% in 2013 reportedly its lowest growth rate in 13 years barring a downturn in 2009) and it continues to deteriorate. Capital outflows are accelerating (more in the first 3 months of 2014 than in all of 2013), the currency has taken a 10% devaluation hit since its Ukrainian incursion leading to higher capital costs for lenders and borrowers alike. If the crisis worsens, the World Bank estimates the economy could move into negative growth territory in 2014 and beyond. Already the World Bank notes, Russia's recent growth-holding *ceteris paribus* oil and gas prices - have been consumer driven and consumer spending is down. In the immediate short term Emperor Putin can probably bank on continued middle class support but we are only at the beginning

March Madness: The Emperor Has No Clothes

Written by Editor
Tuesday, 08 April 2014 00:00

and not at the end of Russia's devolution backwards to some vain and imaginary glorious past. How long his bread-and-butter contingency will tolerate the economic costs of expansionism at the price of the Russian empire he already controls is anyone's guess. One thing for certain is that further Russian incursions into the Ukraine and elsewhere can only lead to furthering damaging the nascent Russian economy and plunge it backwards towards a recession, or worse, that Russians themselves do not want. The other side of this coin is how much the rest of the world, particularly Russia's biggest EU trade partners, are willing to sacrifice to make a point about justice for Ukraine and Russia's unprecedented modern military build-up adjacent to the EU's and NATO's eastern European border.

In the end, Russia has again shot itself in the foot. Mr. Putin's leadership is as starkly threatening as past Soviet regimes which should come to no one's surprise. Russia's foreign and energy policy behavior further signal the extent to which it is willing to return to its former glory days at any price. European policy makers could accelerate decoupling the EU from Russian energy supplies; American policy makers have already called on the EU to energize moves towards their own shale oil and gas revolution, which if launched, could further nibble-away at Gazprom's European market share; a middle-to-long term decline in Gazprom's export position could lead to a gas-rich but market dry Russian gas industry. In the meantime, world observers will necessarily re-assess Russia as an upstanding and predictable state worthy of respect in global affairs. The G8 is now the G7 (Mr. Putin says he could care less), NATO will reassess its posture vis-à-vis its old-new adversary (probably the biggest unforeseen favor Mr. Putin has given the Alliance in many a day) and trade agreements and regimes may be reviewed which can't be good for inward Russian foreign investment and trade. In the end, the Ukraine-Russia crisis is not about energy. This is about power. US President Obama correctly downgraded Russia as a 'regional' power over its smaller or weaker regional neighbors. Once again the Russian emperor has no clothes. A half naked Putin is hard enough to look at. Don't make things worse Vlad. We don't want to go there.