

The Disaster Formerly Known as the USSR

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Bad decisions when times were fat spell a rough road ahead for those who hold their savings in Russian currency.

It is amazing how things change in a few months. In September, Russia was on top of the world, the returning global power. Today, it is slipping into obscurity. If it did not have nuclear weapons, most would not even care what happens.

Russian economic growth in this decade was completely driven by rising commodity prices, mainly of oil and gas. As the global economy goes into recession and commodity prices either decline or remain at today's levels, Russia will relive the horrible 1990s when it defaulted on its debt and suffered from a severe inflation. Think of Russia as a very large oil and gas producing company that is run for the most part by a government that makes General Motors' and Ford's management and autoworkers' unions look like progressive thinkers.

Over the last five years, Russia de-privatized (a clever euphemism for "stole") oil assets from private investors and has been milking petro cash flows from now state-owned oil companies. The government is simply not equipped to manage projects that have a multidecade life. Russia underinvested in exploration and development of oil and gas in the last decade and that is why its oil and gas production is declining.

Communism failed for a reason: Government is a horrible capital allocator. The time horizon and time in office of a government bureaucrat is much shorter than the horizon of an oil company, therefore when choosing between drilling holes in the middle of nowhere that will increase oil production years down the road or raising benefits to retirees, retirees win.

But it gets worse. As oil prices rose, the Russian government decided that it did not need the West anymore. It felt that the contracts it signed with BP and Royal Dutch Shell in the 1990s--when oil prices were much, much lower and no one wanted to invest in Russia--were not advantageous anymore. Using deceptive legal practices, it unilaterally renegotiated those contracts muscling away lucrative projects from these companies.



It is just amazing how things changed in six months. Declining oil prices will likely force Russia to come back to foreign investors begging for investment, but this time it will not receive it. Would you blame them?

Yes, it gets even worse. The return on capital in oil and commodity-related industries was much higher than in any other industry. This siphoned capital from other industries, which caused investments in these industries to decline. The rise of commodity exports drove up the Russian currency, making noncommodity industries even less competitive in the world market. Once you take high commodity prices away, Russia is worse off than it was before.

On top of this, when Russia did well, it acceded to pressures to increase social programs. While the revenues were flowing, Russia paid off its foreign debts and created a Stabilization Fund, a multihundred-billion dollar savings account. But it is hard to say how long this fund will last as Russia spent (wasted) \$57.5 billion on defending the ruble in September.

Russia is strong on a balance sheet basis, but that is a reflection of the past. The future, as reflected in its future income statements, looks horrible. To some degree it is almost a mirror image of the U.S.; our balance sheet is weaker but our earnings power is strong. Despite all the problems we have in the U.S., we have the most diversified economy in the world. Unfortunately, that is not the case with Russia.

The Russian currency will decline substantially over the next several years as Russia will try to print itself out of the problem. Despite the intervention, the ruble already declined close to 20% versus the [U.S. dollar](#) since July, but the decline has only started. Money is leaving Russia, which is why the ruble is collapsing.

[Construction projects big or small came to a halt](#) in September and October. People took their money and ran. I called my childhood friends in Russia last month and advised them to move their ruble denominated savings out of ruble into dollars and/or euros (either should be better than the ruble), preferably also taking their savings out of Russian banks and either transferring into big European banks or just putting them into a safety deposit box.

Yes, unfortunately, I believe the Russian ruble will collapse.

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