

GLOBAL RISKS & THE MOLDOVAN ECONOMY

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*I want to first thank the Ministry of Economics and its National Institute of Economic Research for the opportunity to speak at this conference. I have done so several times in the past and it is always a great pleasure to be with the wonderful people attending the conference.*

*I want to make some observations that are of general importance to all those in attendance.*

**RULE OF LAW**

*There is no International Rule of Law*

*Events of the last 18 months demonstrate that this is not even actively aspirational.*

**I) General International Economic Risks**

In 1996 I was writing observations about a forthcoming bubble in Russia. At the time I was working as a legal consultant for a Russian bank. I observe what I call the “hotel risk”. By this I mean that the explosion in costs for hotel rooms far exceeded the reasonable basis based upon economic growth. This is not in any way a particular criticism of Russia, this is really just what happens in relatively open economies. In 1998, the Asian/Russian mobile broke. At that time, the US economy was relatively strong and was able to provide effective demand for products from many countries. This meant that the 1998 crisis was relatively moderate.

At the same time the US economy was faced with exploding growth in securities, particularly high-tech investment instruments. The asset growth far exceeded the ability of revenue streams to support the asset prices. This led to the 1999-2000 high-tech bust.

1993 I saw a renewal of asset growth in the real estate markets. In the next few years the housing bubble inflated to excess and in 2007/2008 the bubble broke. I had begun writing about this bubble in 2003.

The international capital markets are already expressing concern about the risk position of their portfolios. Although certainly the first increases will be moderate, perhaps on the order of a quarter percent and not more than half of a percent, the markets are so sensitive to the impact of rate increases on equities that almost certainly there will be a flight to risk quality instruments. Most likely this will entail a flight of much international capital into US government bond instruments. Thus, despite Dodd – Frank and Basel III, is quite possible that repetition of Lehman Brothers or AIG events may occur, and quite likely, could be significantly larger in scale. “Too big to fail” will not guarantee against failure.

From Bloomberg BusinessWeek, 12 October 2015, Ben Bernanke speaks in an interview with Charlie Rose: Charlie Rose: when it came time to save AIG you felt you had no choice? Bernanke: We had no choice. It was the world’s largest insurance company. It was connected with all the other major firms in the world. And on top of the Lehman failure, I think it would have basically brought the system down. There’s a very good chance the financial system would have gone completely into stasis. And then, even though we were able to arrest the panic, the economy took a very serious blow. And of course we’d still not completely recovered.

From Bloomberg BusinessWeek, 12 October 2015, Ben Bernanke speaks in an interview with Charlie Rose: Charlie Rose: when you rescued AIG, did you have any control over what did with all that money? Bernanke: Oh, yes. We did. With the money we gave them, they had their obligations. The basic problem is, they came to us and said “look, we’ve got 85 billion collateral calls, margin calls, payments that we have to make this week. We haven’t got the cash, Lend us the cash against our firm, taking the firm as collateral, we can make those payments”. After that, we sent people into AIG just to make sure that we understood what was going on inside the firm. So yes, we were very involved in what AIG did after they received the light.

If we look at the content notes of Bernanke’s comments above, and particularly looking at the growth in Chinese equities, and the almost 2 trillion lost in that market in late August / early September, it’s quite possible that a new run on the markets will occur with the first indication of the Federal Reserve discount rate starting a climb towards normalcy. Normalcy, in this sense could mean interest rates in the range of 4 to 6%.

As a normal flight to quality, the capital flows will move from high risk BRICS and below markets into the more sophisticated markets in Europe and United States.

Writing in an article in the Washington Post entitled “a global economy in peril, ”Lawrence Summers, former Secretary of Treasury, notes that the strongest explanation for this combination of slow growth, expected low inflation and zero real rates is the “secular stagnation hypothesis.” It follows that a combination of higher savings propensity, lower investment propensities and increased risk aversion have operated to depress real interest rates that go with full employment to the point where the zero lower bound on nominal rates is constraining.

He goes on to say that “what is needed now is something equivalent but on a global scale – a signal that the authorities recognize that the secular stagnation is the dominant risk we face. The Fed (U.S. Federal Reserve Bank) must also state its main is to help prevent global financial fragility from leading to a global recession”.

<sup>1</sup> © 2015 Karl William Viehe

The central banks of Europe and Japan need to be clear that their biggest risk is a further slow down.

“If I am right and policy proceeds along the current path, the risk is that the global economy will fall into a trap not unlike the one Japan has been in for 25 years, where growth stagnates but little can be done to fix it. It is an irony of today’s secular stagnation that what is conventionally regarded as imprudent offers the only prudent way forward”. Lawrence Summers, the Washington Post, “a global economy in peril” 8 October 2015.

The world is rather a more complex place than it was 25 years ago at the time of the collapse of the Berlin wall. The United States and the Soviet Union spent decades battling each other for international intellectual and political predominance. United States had always expected that the world would become a more friendly and predictable place were the Soviet Union to collapse. That has not proven to be the case.

In the years of the Cold War there was a rather defined static equilibrium among four major political entities: United States, Europe, the Soviet Union and China. As is the case now, for the most part, the southern hemisphere was not considered a player in international affairs. When the Soviet Union and Eastern Europe dissociated, two decades of political intrigue resulted, now most evident by events in Ukraine and simmering threats to the Baltics and Moldova. Although the result has been a substantial increase in political and economic freedoms in most of the former Soviet Union and Eastern Europe, the countries are confronted with political choices that involve extraordinary political and social economic risks principally due to Russian revanchist politics. If there is a question about his allegation of causality, try the legal “but for” test. Balancing these risks is a very precarious process.

In this brief presentation, I want to make a few observations of what the international community may be facing in the coming months/years.

I) in the coming years Russia will be faced with claims for reparations arising from its conduct in its bordering nations, Ukraine, the Baltics, Moldova, etc. Russia is quite familiar with such reparation claims as it participated, following World War II, in reparation negotiations against Germany. It may be that the claims arising from Ukraine alone will be in excess of \$4 trillion, twice Russian GDP.

II) the international community outside of Russia should not disparage Russia for having made a choice to “reconstruct” (perestroika replayed ??) itself in the model of the owners old Soviet autarchy. This is Russia’s choice. The international community has no obligation to have any economic relationships with Russia. For the most part, that was the case in the 80 years of the Soviet autarchy.

III) is quite possible that the sanctions that have been directed at Russia thus far will be seen as minimal in the view of sanctions that can be applied were Russia to continue its invasive techniques. It is quite possible that the Russian Federation will be “zeroed-out” by future sanctions. This will be perfectly consistent with Minister Lavrov’s call for a “Reset 2,” a reconstruction of the reconstruction = , or, perhaps, a perestroika perestroiki.

As part of future sanctions, it is quite likely that China will be placed in the position of having to choose an exclusionary economic relationship with Russia or continuing economic relationships with North America and the European Union. The economics of that choice are obvious.

It is understood that such a zeroing of economic relationships will be quite expensive for the alliance against Russia, perhaps several trillion dollars or dollars equivalents, but, nevertheless such action will be far less damaging than the nuclear threat that President Putin has placed on the table.

#### II) Russia Risk

At one point President Putin made a remark that the breakup the of the Soviet Union was the greatest geopolitical disaster in history. While it may not have been the greatest geopolitical disaster, I do agree that it was rather unfortunate. The problem was that no one in power at that time had any idea of how to reform the Soviet Union. Had the Soviet Union been able to transform itself into a voluntary association of nation-states, similar to the European Union, it clearly would have been a positive development. However, at that time, none of the politicians that the factor were in charge at any knowledge of the legal structure of a market economy nor did they have anywhere near the capital that would have been required to bring about a transformation. Finally, to those in power in the 15 republics, the attraction of being freed from the yoke of Moscow was simply too attractive to resist.

I would like to make one side note on this issue, in the first half of 1991 I was working with a number of young individuals in the FSU structure. What was proposed was the creation of a Eurasian Multilateral Investment Guarantee Agency similar to the multilateral investment guarantee agency of the World Bank. Indeed into August 1991, we had all 15 republics agreeing to create such an agency. All the papers were drafted and ready to be signed. I left Moscow on 16 August 1991. All of the documents necessary to create the EMIGA were in the hands of those participating. A few days later the coup d’etat in which Gorbachev was held in the south of the country took place. This single event brought the project to a halt.

On 8 December of the same year, the tripartite conference in Minsk brought the Soviet Union to a dissolution. Following this, there was an incursion of all the Western international institutions and organizations offering technical assistance to the republics of the former Soviet Union. The promise of tens of billions of dollars from various sources of international aid siphoned off the interest in the creation of EMIGA.

With the political uncertainty throughout the region and argument can be made that such an agency should again be considered. It’s interesting to note that the current “powers that be” in Russia seem not to understand that empires forcefully constructed are ultimately doomed. The European Union has been forged as a diplomatic construct over 60 years with an extraordinary amount of give and take. Even now, it faces issues with respect to membership, witness the recent proposition for a 2016 referendum that the United Kingdom disassociate itself from the European Union, the recent vote of Scotland to secede / disassociate itself from the United Kingdom and the notions of the Shetland Islands to withdraw from Scotland. In

Canada, there has long been a movement for Quebec to secede. In the United States, there is a movement in Texas for that state to secede from the nation.

As for businesses, consider the Russian risk with respect to strategic planning as follows. If Russia is willing to expropriate property of Crimea with a total absence of any process other than military action, facing a future investment of six to \$10 billion, that is, essentially an investment with a negative asset value of \$10 billion, why would Russia have any hesitation to take over a foreign investment with a large capital investment and or a cash flow.

Looking at the “political” history of foreign investment in Russia over the past two decades, it’s quite likely that the powers that be in the Kremlin would have little compunction to restrain from expropriating any foreign investment.

Faced with voluminous legal claims resulting from its oil-spill in the Gulf of Mexico, Deepwater Horizon, 20 April 2010, almost five years later, at least, litigation is still proceeding with legal claims by both BP and various opponents. Such legal process will not be the case in the Russian legal system. Of that, the company can be sure.

I) in the coming years Russia will be faced with claims for reparations arising from its conduct in its bordering nations, Ukraine, the Baltics, Moldova, etc. Russia is quite familiar with such reparation claims as it participated, following World War II, in reparation negotiations against Germany. It may be that the claims arising from Crimea alone, based on standard methods of asset valuation, will be in excess of \$4 trillion, twice Russian GDP. It is quite possible that east Ukraine claims may be twice that amount.

II) the international community outside of Russia should not disparage Russia for having made a choice to “reconstruct” (perestroika replayed??) itself in the model of the owners old Soviet autarchy. This is Russia’s choice. The international community has no obligation to have any economic relationships with Russia. For the most part, that was the case in the 80 years of the Soviet autarchy.

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As part of future sanctions, it is quite likely that China will be placed in the position of having to choose an exclusionary economic relationship with Russia or continuing economic relationships with North America and the European Union. The economics of that choice are obvious: \$30 T GDP +/- for the US/EU trading relationship verses ten percent of that for Russia and it friends.

It is understood that such a zeroing of economic relationships will be quite expensive for the alliance against Russia, perhaps several trillion dollars or dollars equivalents, but, nevertheless such action will be far less damaging than the nuclear threat that President Putin has placed on the table.

#### V) China Risk

China has made a remarkable, extraordinary investment in its infrastructure. Although the country was late to the modernization game, the quality of its infrastructure is quite good. It remains to be seen whether the maintenance of the infrastructure will be on a par with its construction.

The problem I see in China is that its political establishment continues to flood the economy with capital from various sources with no certainty that the capital will be placed in productive. Asset values have exploded but it is quite possible with all the overproduction of housing and manufacturing facilities the return on capital is significantly negative. There is little doubt, however, that the central government will continue to flood the markets with capital. Quite possible that China could open its doors to foreign participation in the economy which can absorb much of the overstock of capital assets. The problem is that China would have to do so with a little attitude towards political economy.

At some point in the future, China will face the same issues of dissolution that the Soviet Union / Russia faced in the late 1980s and 1990s. It’s not at all clear how those issues will sort out, and certainly China has more overall social homogeneity than the former Soviet Union had prior to its break up.

#### VI) United States Risk

United States faces much of the same risks of every other country with respect to its capital markets. Almost \$2 trillion of ex-pat capital resides offshore due to the burdensome tax structure in the United States. As we move towards election this will become a topic of much discussion among the politicians. The United States also has a tax code that is extraordinary burdensome. However, it is unlikely that the politicians will formulate a restructured tax code that will make it attractive for its citizens and domestic and foreign investors. It is top-down in every election cycle and forgotten the action takes place.

United States also has a very serious problem with its relationship in the international community. It is quite arguable that many of its historic alliances are jeopardized by the concern that United States will not stand behind its assurances in forthcoming conflicts with Russia.

Is quite possible that the stress to the international relationship with Russia quite likely will lead to a hardline result in the forthcoming 2016 elections.

*The Wall Street Journal*

*NOTABLE & QUOTABLE*

*Notable & Quotable: Ronald Reagan*

*‘We find ourselves increasingly in a position of dangerous isolation’.*

*Oct. 6, 2014 7:09 p.m. ET*

*From Republican presidential candidate Ronald Reagan ’s address to the Veterans of Foreign Wars Convention in Chicago, Aug. 18, 1980:*

Soviet leaders talk arrogantly of a so-called “correlation of forces” that has moved in their favor, opening up opportunities for them to extend their influence. The response from the administration in Washington has been one of weakness, inconsistency, vacillation and bluff. A Soviet combat brigade is discovered in Cuba; the Carter Administration declares its presence 90 miles off our shore as “unacceptable.” The brigade is still there. Soviet troops mass on the border of Afghanistan. The President issues a stern warning against any move by those troops to cross the border. They cross the border, execute the puppet President they themselves installed in 1978, and carry out a savage attack on the people of Afghanistan. Our credibility in the world slumps further. The President proclaims we’ll protect the Middle East by force of arms and two weeks later admits we don’t have the force.

Is it only Jimmy Carter’s lack of coherent policy that is the source of our difficulty? Is it his vacillation and indecision? Or is there another, more frightening possibility – the possibility that this administration is being very consistent, that it is still guided by that same old doctrine that we have nothing to fear from the Soviets – if we just don’t provoke them.

Well, World War II came about without provocation. It came because nations were weak, not strong, in the face of aggression. Those same lessons of the past surely apply today. Firmness based on a strong defense capability is not provocative. But weakness can be provocative simply because it is tempting to a nation whose imperialist ambitions are virtually unlimited.

We find ourselves increasingly in a position of dangerous isolation. Our allies are losing confidence in us, and our adversaries no longer respect us.

*Frankfurter Allgemeine*

*President of Bulgaria*

In Bulgaria, President Rosen Plevneliev said in an interview with Germany’s Frankfurter Allgemeine published over the weekend that "Russia must learn to have partners, not vassals and subjects".

"We all want as a partner a country that has produced Tchaikovsky, Tolstoy and Dostoevsky," Plevneliev was quoted as saying. "But facts show that today we have to deal with another Russia – with a nationalist, aggressive state under a president who does not regard Europe as a partner, but as an opponent".

*Italy – La Stampa*

*Lech Walesa*

Poland’s legendary Solidarity Movement leader, Nobel Peace Prize laureate and former President Lech Walesa urged NATO to station nuclear missiles in Poland to deter a potential Russian threat in an interview with Italy’s La Stampa published Monday.

Putin is irresponsible and wants to sow havoc in Poland, as he did in Ukraine," Walesa was quoted as saying. "So we want NATO to give us the best missiles at its disposal, install them here and point them in the right direction".



#### Bulgaria Plans to Ground Its Russian-Made Fighter Jets

- By Anna Dolgov
- Oct. 07 2014 10:40
- Last edited 10:40



Lucas Jackson / Reuters Roshen Plevneliev, President of Bulgaria, addresses the 69th United Nations General Assembly at the U.N. headquarters in New York September 25, 2014.

Bulgaria’s military will scrap three dozen of its Russian-made fighter jets and bombers to reassert its independence from Moscow, the defense minister said, following the Bulgarian president’s denouncement of Russia as a "nationalist, aggressive state".

The plan to get rid of all Russian-made aircraft is part of Bulgaria’s military development program through 2020

to further integrate the former Soviet bloc nation into the Western NATO defense alliance, of which it is a member, Bulgaria’s Trud newspaper reported Monday. The military will present to parliament within six months a list of new airplanes to replace the 15 Russian-made MiG-29 and six MiG-21 fighters and 14 SU-25 bombers that remain in Bulgaria’s air force, the report said.

The plan, which Defense Minister Velizar Shalamanov described as a bid to strengthen Bulgaria’s independence from Russia, is expected to go ahead despite protests by pilots and maintenance workers who expect the replacement of aircraft to cost 300 jobs, Trud reported.

Russia’s annexation of Crimea and its meddling in eastern Ukraine has prompted a series of moves from eastern European nations to boost their ties with NATO and strengthen defense against their former Moscow masters.

Poland’s legendary Solidarity Movement leader, Nobel Peace Prize laureate and former President Lech Walesa urged NATO to station nuclear missiles in Poland to deter a potential Russian threat in an interview with Italy’s La Stampa published Monday. "Putin is irresponsible and wants to sow havoc in Poland, as he did in Ukraine," Walesa was quoted as saying. "So we want NATO to give us the best missiles at its disposal, install them here and point them in the right direction".

In Bulgaria, President Rosen Plevneliev said in an interview with Germany’s Frankfurter Allgemeine published over the weekend that "Russia must learn to have partners, not vassals and subjects".

"We all want as a partner a country that has produced Tchaikovsky, Tolstoy and Dostoevsky,"Plevneliev was quoted as saying. "But facts show that today we have to deal with another Russia – with a nationalist, aggressive state under a president who does not regard Europe as a partner, but as an opponent". A recent survey by Russia’s independent Levada Center pollster has indicated that years of President Vladimir Putin’s rule have caused Russians to abandon their wish for a European future for their country.

Despite harsh anti-Western rhetoric by Russia’s state-run television channels, the number of Russians who wanted their country at some point to join the European Union had remained in a comfortable majority during the initial decade of Putin’s government, but went into a nosedive a few years ago and hit an all-time low of 16 percent last month, according to Levada Center polls.

Bulgaria’s president told Frankfurter Allgemeine that "all Europeans have won with the fall of the Berlin Wall, gaining freedom, democracy, perspective".

"However, Vladimir Putin sees the fall of the Wall and the collapse of the Soviet Union as a catastrophe, which leads to his interpretation of history that opposes Europe and its values as a matter of principle," Plevneliev was quoted as saying.

## The Moscow Times

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Finance Minister Urges Defense Budget Rethink Amid Bleak Economic Forecast

- By Matthew Bodner
- Oct. 07 2014 18:16
- Last edited 18:16



Maxim Shemetov / Reuters Russia’s Finance Minister Anton Siluanov speaks during the Reuters Russia Investment Summit in Moscow.

Russian Finance Minister Anton Siluanov says that Russia will not be able to afford its current level of military spending in the long term, as an economic slowdown amid declining oil prices and Western sanctions forces Moscow to drastically alter the expected funding environment.

Russia is currently pursuing a 20 trillion ruble (\$500 billion) rearmament program through 2020, and announced last month that another defense program with comparable spending is in the works for 2016-25.

The 2016-25 rearmament plans, however, may not enjoy the same lavish level of funding as the ongoing program. "We want to reconsider the amount of resources devoted in the course of this new program, so that they are more realistic," Siluanov was quoted by RIA Novosti as saying Tuesday.

Siluanov explained that the current proposals for the program were formulated when Russia’s economic outlook

was brighter. But Russia's economy has suffered from various punitive measures enacted by Western governments over Moscow's annexation of Crimea in March and its alleged role in Ukraine's crisis. U.S. and EU sanctions, besides targeting specific Russian companies and individuals, have also made many foreign bankers skittish over investing in any companies based in Russia.

Meanwhile, the declining value of the ruble, rising inflation, and falling oil prices have forced the Economic Development Ministry to halve their growth forecast for next year to 1 percent.

"Right now we simply cannot afford to carry out [the 2016-25 armament plan] and will work out a means to determine what can be funded by the budget with the defense minister," Siluanov said at a Federation Council hearing.

Various statements from defense officials in recent months have painted an increasingly ambitious picture for the Russian government's military modernization goals. Most recently, Deputy Prime Minister Dmitry Rogozin said that Russia's nuclear forces – the backbone of Russian military power – would be completely outfitted with new missile systems by 2020. Despite the strain on the federal budget, some analysts have said that high spending on defense helps boost the economy. A report released by Moscow's Higher School of Economics in late September showed that military and related defense expenditures, such as "the production of ships, airplanes, spacecraft and other means of transportation", was one of the primary driving forces of a surge in industrial production.

However, the report cautioned that these developments mask stagnation across most other areas of manufacturing.



#### Draft Law Allows Russia to Seize Foreign Assets in Response to Sanctions

- Reuters
- Sep. 26 2014 10:57
- Last edited 10:57



Yevgeny Razumny / Vedomosti Russia's economy is set to stagnate in the next two years as the country pays the price for the Ukraine crisis. Russian courts could get the green light to seize foreign assets on Russian territory under a draft law intended as a response to Western sanctions over the Ukraine crisis. The draft, which was submitted to parliament on Wednesday by a pro-Kremlin deputy, would also allow state compensation for an individual whose property is seized in foreign jurisdictions.

Italian authorities this week seized property worth about 30 million euros (\$40 million) belonging to companies controlled by Arkady Rotenberg, an ally of President Vladimir Putin targeted by the U.S. and European Union sanctions. The draft law, published on a parliamentary database, would allow for compensation for Russian citizens who suffer because of an "unlawful court act" in a foreign jurisdiction and clear the way to foreign state assets in Russia being seized, even if they are subject to international immunity.

Boris Nemtsov, a Kremlin critic who in the late 1990s was a senior member of government, said the bill was an attempt by Putin to shield Russian billionaires and officials from the impact of sanctions.

"What is a strongman's friendship like?" he asked rhetorically on his Facebook page. "It is when your four villas, apartment and hotel are seized in Italy, and your accomplice in the Kremlin immediately introduces a bill to compensate for the losses from the Russian budget".

Russia and the West are locked in their worst standoff in decades over the Ukraine crisis. Western powers have introduced several sets of sanctions against Moscow, ranging from visa bans and asset freezes to caps on access to overseas capital markets for Russian firms. Russia responded by introducing food bans against EU agriculture producers and has threatened more retaliatory measures if the West presses ahead with sanctions.

Russia's economy is set to stagnate in the next two years as the country pays the price for the Ukraine crisis, lack of structural reforms and uncertain economic policy, the World Bank said in a report this week.

Russian laws require three readings in the lower house and the approval of the upper house before going to Putin to be signed into law.