



**BSERVATIONS**  
United-ICAP

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Russia and the 'Oil Weapon'

12 Aug 2014

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## Oil Exports and the Russian Economy - 2012 figures

Oil and Gas exports account for:

- 52% of the Federal Budget
- 70% of total exports
- 30% of GDP

Budget break even crude price: \$117.00

Russia is the 3rd largest producer of crude oil:

1. Saudi Arabia
2. USA
3. Russia

2012 Production and Exports

- Production: 10.4 million bbl/d
- Exports: 7 million bbl/d

However, without a dramatic surge in new exploration Russian production is expected to shrink from 10.4 mil bpd to 8 mil bpd by 2020, a drop of one-fifth.

## Corruption, Gazprom, and the Russian Economy

The 2013 Transparency International Corruption Perceptions Index ranks Russia 127 of 177 countries. For the year that began Putin's second term Russia fell from #90 to #126, a fall of 36 places in one year.

Gazprom, which produces 75% of Russian gas and supplies 25% of Europe's Natgas, is consistently rated as one of the most corrupt companies in the world. The Moscow Times likens it to a crime syndicate. The Peterson Institute for International Economics estimates that although Gazprom posted nominal profits of \$46 billion in 2011 it lost over \$40 billion to corruption and inefficiency. No big surprise there, as it is estimated that corrupt officials take one third of the government's annual budget.

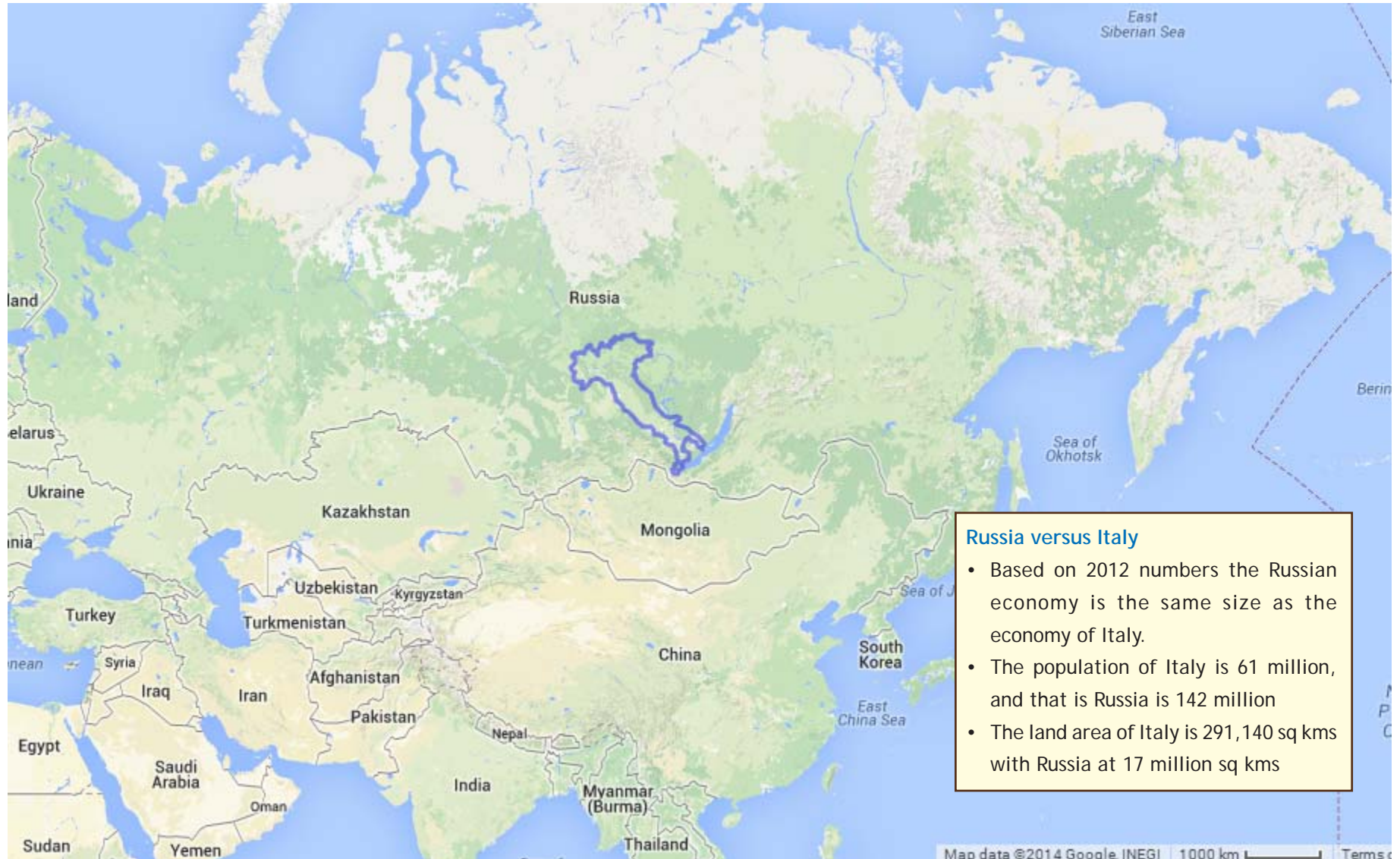
Gazprom production has been stagnant since 2001. The IEA estimates Russia must spend \$730 billion by 2035 just to keep current production levels steady. And in the Euro-zone, its biggest export market, Gazprom continues to lose market share to Statoil and Qatar.

## Quality of Life in Russia

The 2014 Global Peace Index ranks countries by violence levels. Syria came in at the bottom #162 of 162 countries ranked. Russia came in at #152 between Nigeria at #151 and North Korea at #153. In the 2013 OECD 'Better Life Index' Russia ranking the 5th worst



Map Overlay: Italy over Russia

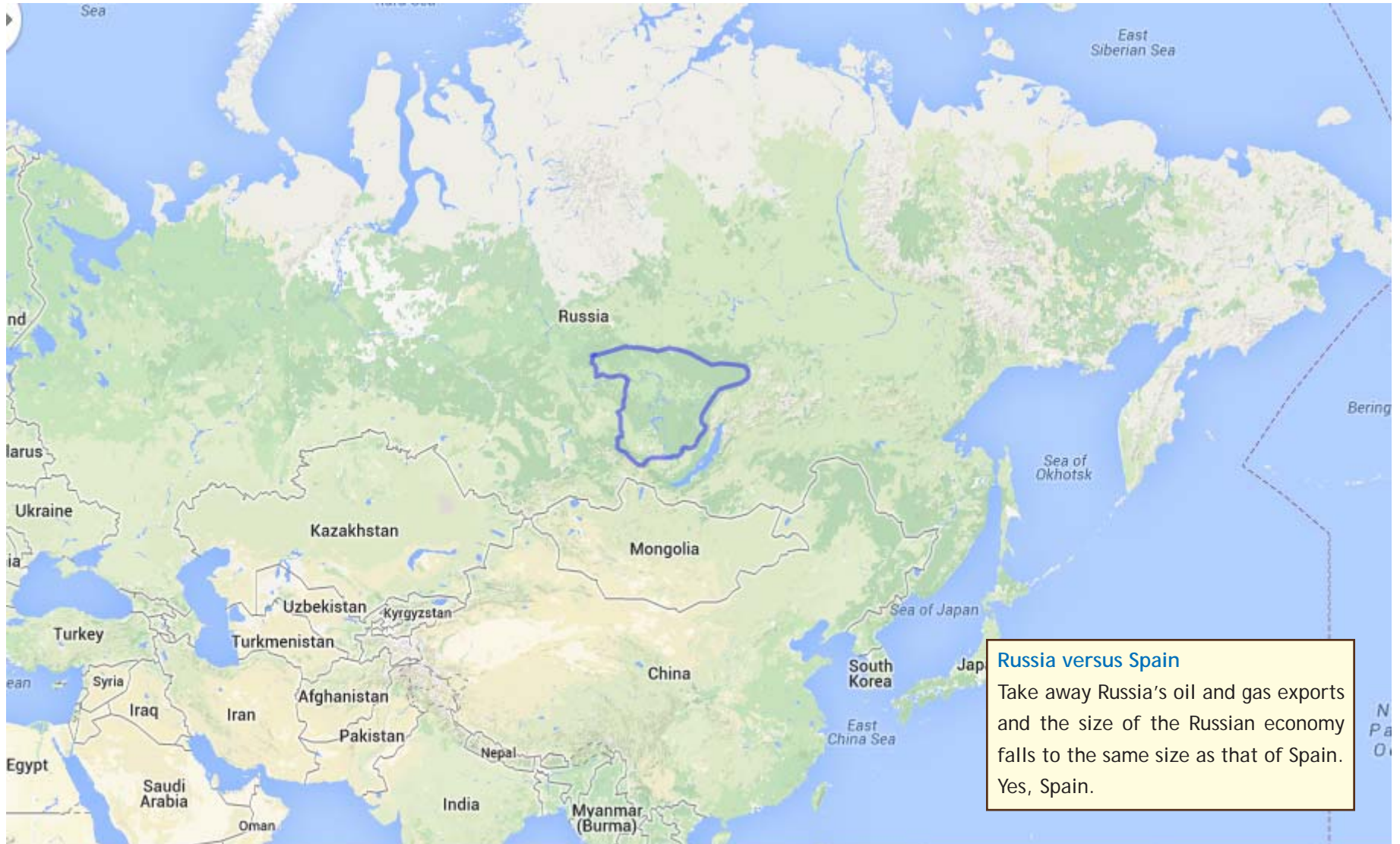


**Russia versus Italy**

- Based on 2012 numbers the Russian economy is the same size as the economy of Italy.
- The population of Italy is 61 million, and that of Russia is 142 million
- The land area of Italy is 291,140 sq kms with Russia at 17 million sq kms



Map Overlay: Spain over Russia



**Russia versus Spain**  
Take away Russia's oil and gas exports and the size of the Russian economy falls to the same size as that of Spain. Yes, Spain.



### Russian Geo-Politics and the 'Oil Weapon'

On a rather frequent basis some reporter somewhere asks whether Putin will opt for the 'oil weapon' if he cannot get his way in the Ukraine. The reporter then goes on to suggest that Putin could jack up Natgas prices in the middle of the winter. First of all Natgas is not an oil weapon. Second, Europe already has more than enough motive to seek out sources of Natgas other than Gazprom. If Putin's goal is to bankrupt Gazprom then jacking up Natgas prices in the middle of the winter is a great way to chase away clients to Statoil and Qatar.

### The Real Oil Weapon

The information on the preceding pages strongly suggests that the real oil weapon is the one that the West can deploy against Putin. And there is a precedent for it.

Those fond of feeding the Pentagon with large weapons packages like to think that the Soviet Union went bankrupt because it could not compete with the new military spending initiated by President Reagan. However those advocates of ever increasing US military spending seem to have overlooked the massive stock pile of Soviet nukes. The Soviets did not need to compete in a new arms race. Instead I would like to suggest that Paul Volcker was much more directly responsible for the fall of the Soviet Union than Ronald Reagan ever was. The problems of the Soviet Union were never military problems. They were economic problems. Bankruptcy is an economic condition, not a military one.

### Some Economic History

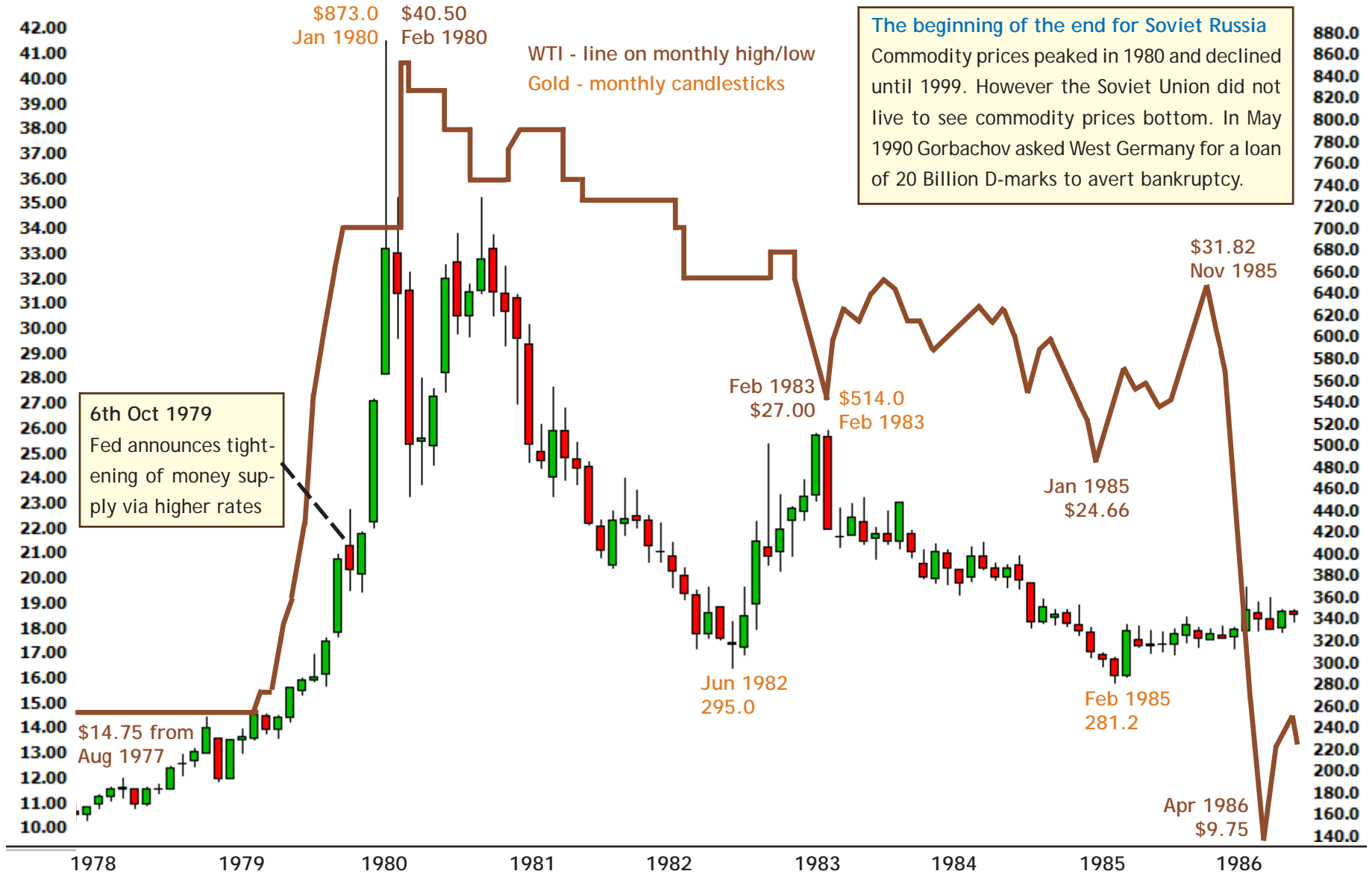
Soviet adventurism and the propping up of all its subsidiary states was funded by the sale of commodities, Crude Oil in particular. The Soviets could afford all this because Crude and Gold were priced so high. Commodities like Crude and Gold were priced so high because the US Dollar was valued so low. The weak US Dollar was directly supporting the troublemaking activities of the Soviet Union. However this was not the motivation behind the Fed jacking up interest rates. The Fed had some serious inflation to fight.

At first no one believed the Fed had the stamina to stay the course. So after the 6th October 1979 Fed announcement Gold and Crude Oil continued to rally for a few weeks. See next page. However once it became clear that the Federal Reserve was not going to buckle under the pressure from those unhappy with higher rates, it was all over for sky high commodity prices. The DX Index bottomed at 82.00 in late 1978 and reached 165.00 by early 1985. WTI fell from over \$40.00 in early 1980 to less than \$10.00 by early 1986. Gold fell from \$873.0 to a \$280.0 low. At these prices the Soviet adventure was doomed.

Paul Volcker killed off inflation and the Soviet Union with the same strong US Dollar. Two birds, one stone. Of course at the time no one seemed able to foresee that a collapse in commodity prices could bring down the Soviet Union. But it most assuredly did just that. So not all unforeseen consequences are negative.



**The beginning of the end for Soviet Russia**  
Commodity prices peaked in 1980 and declined until 1999. However the Soviet Union did not live to see commodity prices bottom. In May 1990 Gorbachov asked West Germany for a loan of 20 Billion D-marks to avert bankruptcy.





### Putin is not an economist

Vladimir Putin has called the collapse of the Soviet Union the greatest catastrophe of this century. He aims to right that perceived wrong.

It seems pretty obvious to most everyone that he longs for glory days that never existed. It is said that nostalgia is not about remembering but about forgetting. That clearly applies in Putin's case. He seems to have forgotten that the Soviet empire was economically unsustainable. He seems to have forgotten that it went bankrupt. And he seems oblivious to the fact that the rest of the world remembers what he has chosen to forget. We can only hope that he will soon realize that no amount of bombing his neighbors is going to bring back a state that was an economic and ethical disaster. However if his memory continues to fail him, and if he continues unable to learn from his own experiences then it is not as if the rest of the world has no recourse. There is a tried and true way to burst Putin's bubble of forgetfulness.

Any strengthening of the US Dollar here will have the same effect on commodity prices that it had back in the 1980's. A strong US Dollar and high commodity prices have always been incompatible. Putin's Russia is much more dependent on high Crude Oil prices than the Soviet Union ever was. This means Putin's Russia is more dependant on a weak US Dollar than the Soviet Union ever was. And what makes Putin's grand strategy even more futile than it might look at first glance is the fact that key economic cycles are trending against him.

### The Economic Cycles

Of the longer term time cycles two are especially toxic for Putin.

1. The 16 year cycle in the US Dollar was due to bottom in March 2008 and is now pointing up into 2016. See page 8.
  2. The 15 year commodity price cycle points down into 2016. Page 9
- Putin is trying to reconstruct the glory days of the Soviet empire with a commodity based economy during a cyclical down trend in commodity prices. Good luck with that Vladimir. But it gets worse for him.

### The Ages of Man

From the rise of the Pharaohs until the fall of Rome success was based on slavery. Wars were fought to gather slaves and he who had the most slaves won. From the fall of Rome to the rise of the Renaissance success was based on religious dogma. Wars were fought over religion and he who had the most compelling dogma won. From the Renaissance until Hiroshima success was technology based. He who had the most powerful technology won. We now live in the age of economics where economic warfare is just starting to come into its own. And today whoever controls the money supply wins.

Putin cannot enslave whole countries like Hitler enabled Stalin to do. Nobody except ISIS fighters believe in dogma anymore. Technology must now prove its economic worth. Russia has no economic clout and Putin's long obsolete tactis will not help. Putin can stir up trouble for a while, but he cannot endure by fighting the trends of time.



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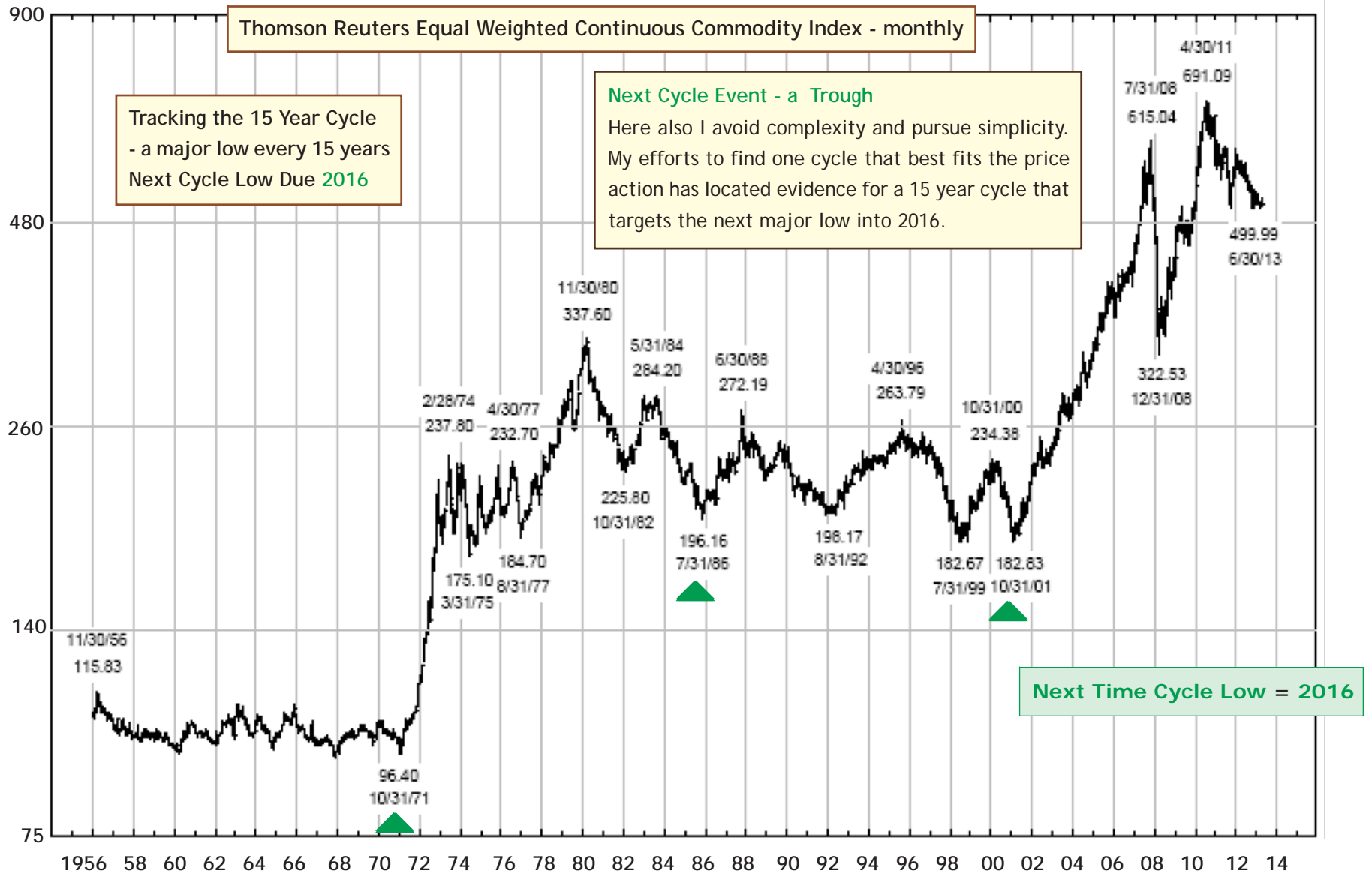
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Plaza Accord,  
Gold Bottoms

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### Welcome to the Age of Economic Warfare

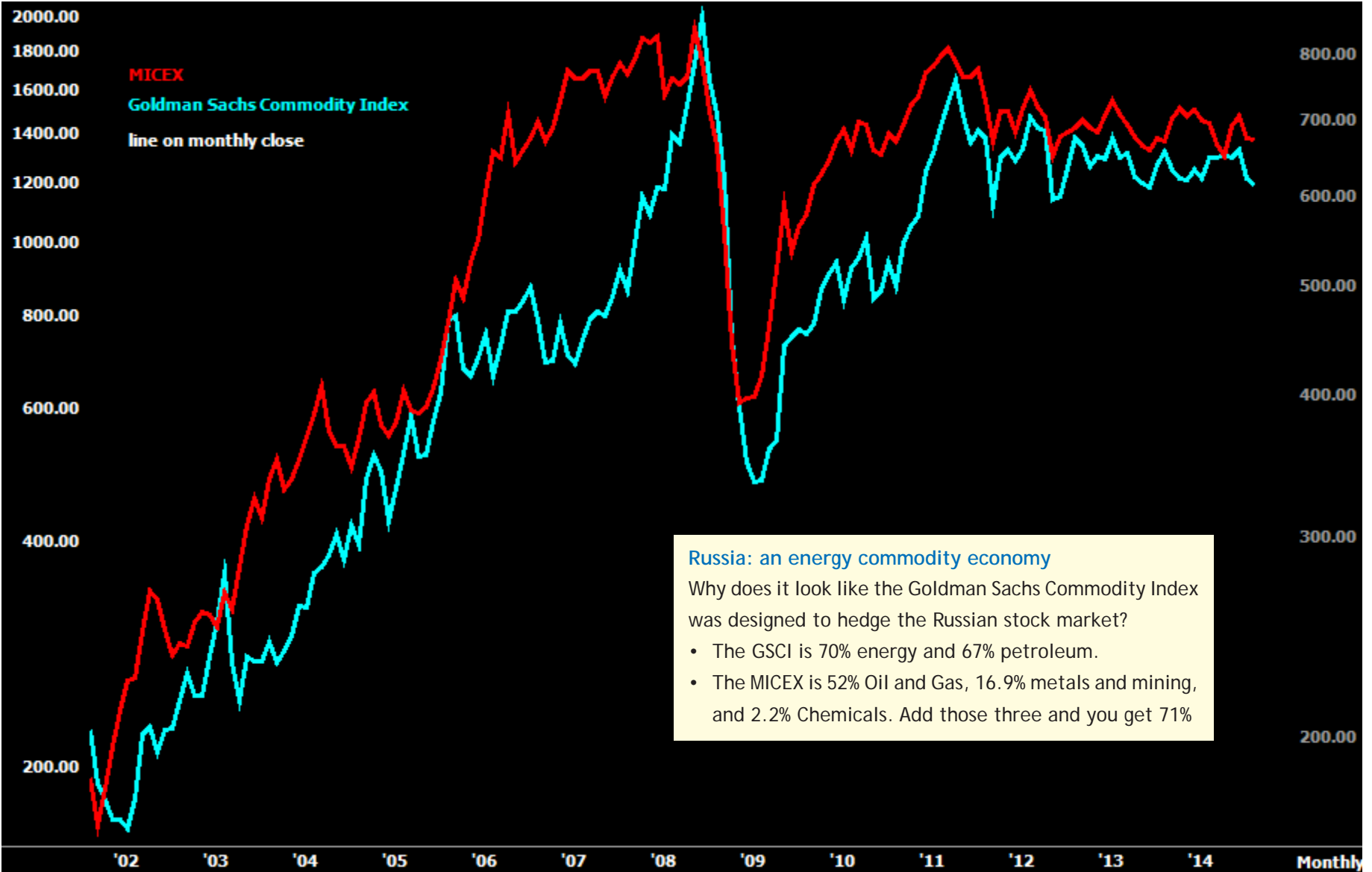
- Emperor Constantine may not have been the first to notice that religious zealots fight much more intensely than slaves. But he was arguably the first to harness religious conviction in the name of empire building. Others would follow his example.
- Martin Luther was certainly not the first to notice major flaws in the dogma of a religion. But he was arguably the first to popularize an alternate dogma that aimed to empowered individuals in this life instead of rewarding them in a future life. This because a trend.
- James Watt was the not the first to build a steam engine, but he was the first to harness it to continuous rotation. This simple rotation marked the birth of the industrial revolution.
- The whole world realized at once that atomic warfare was a dead end for the human race, not a new beginning. Economic warfare has been the activity of choice for successful conquerors ever since.

In this age of instant communication, where all knowledge is available with a few key strokes, anyone who attempts to resurrect an earlier age with long obsolete methods is instantly recognized as a throw back. That we are all a bit shocked whenever such living fossils appear is a testament to the progress the human race has made.

If Putin persists in stirring up trouble he will only create the political will to strengthen the US Dollar and drive commodity prices lower. These trends are already in force. Putin can only hasten their onset.



*"You're right. It does send a powerful message"*





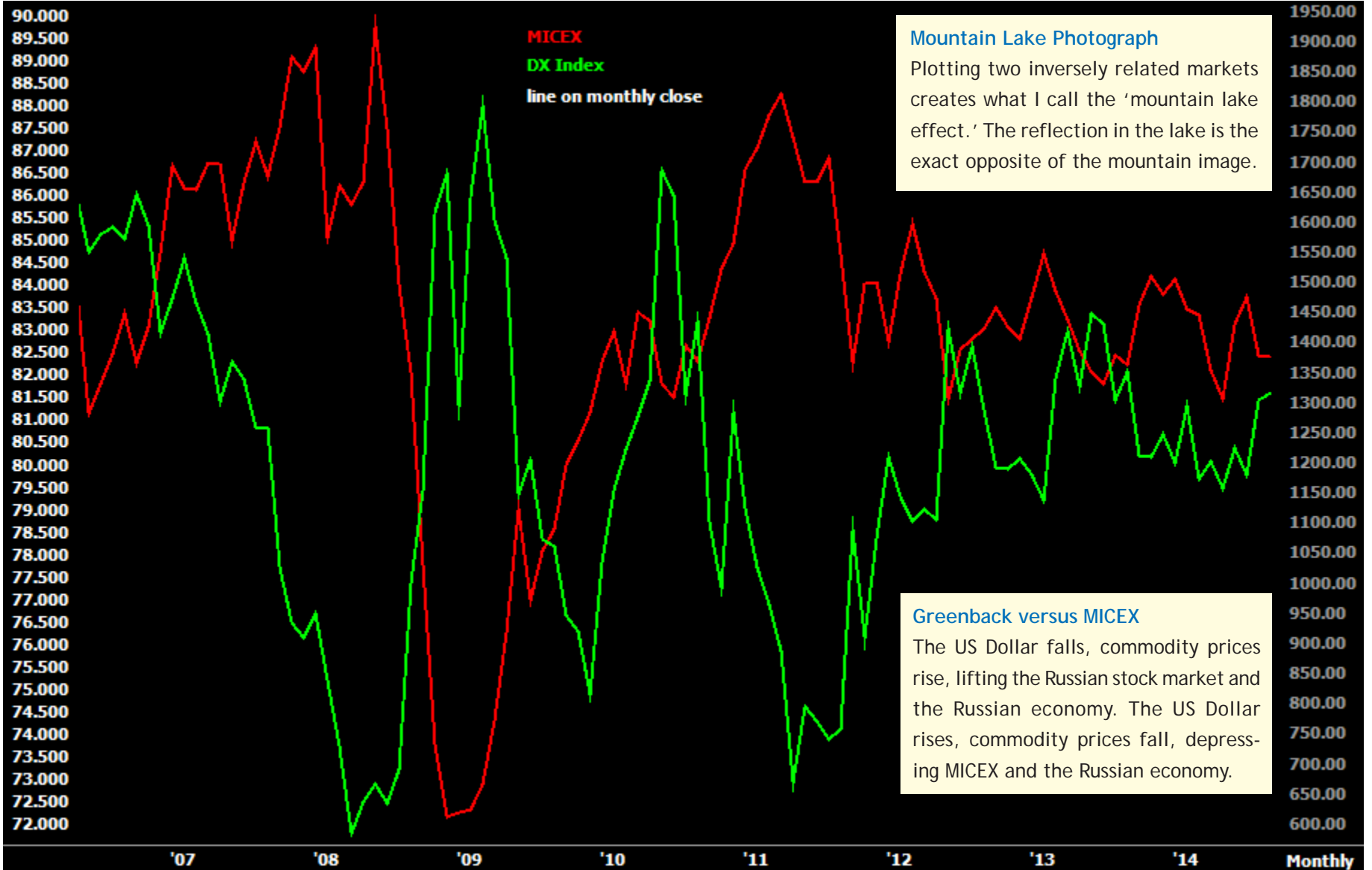
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**Mountain Lake Photograph**  
Plotting two inversely related markets creates what I call the 'mountain lake effect.' The reflection in the lake is the exact opposite of the mountain image.

**Greenback versus MICEX**  
The US Dollar falls, commodity prices rise, lifting the Russian stock market and the Russian economy. The US Dollar rises, commodity prices fall, depressing MICEX and the Russian economy.