A Solution to an Unfair Question

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The last issue of the Skeptic's Almanac posed a rather unfair question. That was to determine the level of U.S. equity prices as well as precious metal prices in the scenario of an economically vibrant and resilient Russia. It is an interesting question insofar as the economic problems of Russia and other emerging nations are believed to pose serious challenges for U.S. economic growth.

The most obvious scenario is to hypothesize worldwide inflation. The currently substantial sovereign debts of the emerging nations would decline in real terms, and, since most of these nations are commodity producers, the proceeds of higher commodity prices would create the capital to continue development. Of course, such virtuous circles contain the seeds of their own destruction insofar as higher commodity prices lead to higher commodity production which, in turn, leads ultimately to lower commodity prices.

Let us therefore create a scenario based upon a random, hypothetical event. A certain General Ivankov (fictional, of course) was in command of the 38th Army Tank division which, in December of 1998, was engaged in war games 40 miles west of Moscow. Due to his recent assignment to Moscow Military District headquarters in Chapayevskiy Lane, he was, unlike other general officers, intimately familiar with the deployment of Russian military forces in the Moscow region. Ivankov was a charismatic officer who graduated with honors at the General Staff Academy during the Soviet era. His training in Soviet military doctrine by no means made him a communist. However, Ivankov clearly had no use for the current political leadership, and was appalled at the chaos into which his country had fallen.

For the purposes of the war games, Ivankov was temporarily assigned command of two additional army tank divisions as well as the 69th Attach Helicopter Regiment and three airmobile assault brigades. Thus, he commanded all of the significant military forces in the Moscow region. Since the war games postulated the movement of a large armored force to attack Moscow from the west, he could move forces very close to the city without alarming any government officials. He did this with guile on the night of December 28, 1998. In the morning, in accordance with his preconceived plans, his forces moved into the city and seized control of all government buildings and declared a new military government for Russia. Given the winter season, the dispersal of military forces throughout Russia, the lack of funding and the fact that most general officers sympathized with Ivankov, there was no significant force to oppose a military takeover.

It was no surprise that the new military government moved immediately to curtail personal liberties. However, perhaps surprisingly, the government did nothing to interfere with the private economy apart from ruthless measures to collect previously uncollected taxes. In fact, the government soon demonstrated its friendliness to western capital investment. It granted many western companies natural resource concessions in exchange for small initial payments and ongoing royalties of 25-35% of the value of minerals extracted. This could be in cash or in kind.

The fact that mineral concessions could be acquired for nominal payments attracted much capital to Russia, and gold, petroleum, copper, diamond and other mineral production increased dramatically. Precious metals as well as oil prices stayed low. However, Russian market share did increase and the government treasury coffers began to gradually fill.

Although General Ivankov was not a believer in state economic planning, his background in logistics created a disposition towards government involvement in the economic process. After all, a military quartermaster estimates the supplies that an army needs, and those supplies are delivered on time, even in wartime and despite enemy efforts to disrupt supply. Ivankov believed that Russian industry, left to its own devices, would never achieve the scale sufficient to be competitive with western companies unless the government offered assistance. Thus, the Russian government routinely purchased shares of new companies in critical industries such as computers and software. Moreover, the military frequently made its research and even its personnel available for use in industry.

For example, the army cryptology unit worked with the staff of the Genii software company to develop secure communications for commercial transactions on the Internet. The first significant takeover of an American software company by a Russian company was the $20 billion acquisition of First Data Corp. by Genii, which was made possible by the investment of the Russian Federal Government in a Genii issue of convertible preferred shares. Genii listed its common shares in the U.S. in ADR form in April, 2001.

American and European investors were very favorably disposed toward Russian shares given the government financing that was made available. Russian government investment assured these firms of access to low cost capital in very large quantities. Not surprisingly, many Russian shares such as GAZPROM, ROSNEFT, TATNEFT and LUKOIL traded at price earnings multiples well above those of comparable American companies. There were many acquisitions of American companies by Russian firms on a stock-for-stock basis.

Officials at the U.S. State Department were alarmed at these developments, as were members of Congress. Although Russia had theoretically opened its borders to unrestrained American investment, as a practical matter the American companies could acquire very few Russian firms given the large government holdings of equity.

Other foreign nations such as China and India emulated the Russian model and the U.S. stock market appreciated as a consequence of continual foreign investment. The bid for Microsoft was not unique insofar as other acquisitions began to be made with active Russian governmental involvement. In some cases, the government would implicitly or explicitly guarantee debt assumed by the acquiring company. In other cases, the government would participate in a tender by offering units of state-owned enterprises that were greatly valued by investors since they were perceived to be growing far more rapidly than comparable American shares. Finally, the Russian government began to offer mineral certificates in exchange for shares. The mineral certificates were redeemable at some future date into delivery of given quantities of gold and petroleum. The mineral certificates were a stroke of genius inasmuch as they enabled the government to monetize assets with no current cash earnings and low present value in exchange for cash-earning enterprises.

The mineral certificates did drive the price of gold below the cost of production, as was the case with petroleum. On the morning of the Microsoft acquisition announcement, gold sold for $224 per ounce and West Texas Intermediate crude oil sold for $9.72 per barrel.

Investors cheered the news of the Microsoft acquisition offer, and the Dow Jones Industrial Average rose 188 points to close at 17,353.18. Thus, President John F. Kennedy Jr. faced a serious policy dilemma. On one hand, an interruption of the policy of free international capital flows would end the period of prosperity that the United States had enjoyed for two decades. On the other hand, it might be dangerous to permit significant portions of American industry to come under foreign control.

The unfairness of such problems is evident. Every policy, if pursued consistently, has unintended consequences, since human beings adjust their behavior to maximize gain in relation to those policies. Perhaps this is the reason that economics is known as "the dismal science."