

## Russia after the War with Georgia: Winner or Loser?

By Julian Schäfer

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During August 2008, the world was shocked by the bloody war in the Caucasus region. Although information from war zones is never completely reliable, the current state of affairs suggests that Georgia shelled Tskhinvali, capital of the separatist South-Ossetia province on 7<sup>th</sup> August. Within hours after the bombardment had begun, about 20,000 Russian troops moved into Georgia, rapidly defeated the Georgian army and occupied the separatist provinces and adjacent security zones. It still remains unclear whether Tbilisi started the conflict because of gross miscalculation of the situation, or because it had been tricked to start the war by Russian intelligence. But it is absolutely undisputable that Russia had won the war by military terms.



Russia: Winner...?

Russian soldiers fighting in Georgia

However, despite the clear military victory, Russia is one of the biggest losers of this conflict. Given the overwhelming military triumph, this verdict seems to be daring. But a stringent analysis of this conflict from a liberal point of view must reach such a conclusion.

Ludwig von Mises, one of the most out-spoken liberal thinkers, dealt with the topics of war, peace and liberal foreign policy in his book „Liberalismus“. Although published in 1927, its main ideas still provide an excellent blue-print for the analysis of current political affairs.

Von Mises argues that prudent foreign policy should always try to avoid military conflicts. To develop his argument, he differentiates between three different attitudes towards the use of violence as a political means.

The first attitude refuses to consider military power an option for politics, because of philanthropic considerations. Philanthropists try to convince rulers not to wage war, even if they are likely to win, because of the suffering that it causes. Therefore, it would be morally superior to stick to peaceful means, even if this entails abandoning possible gains. Von Mises refutes this argumentation, as it only refers to the sacrifices that have to be made, although waging a war might offer great gains. But a rational human being is not likely to forgo prospective benefits for some abstract idealistic norms. Thus, any philanthropic argument has to be considered as comparably weak<sup>1</sup>.

The second possible attitude towards the use of war can be found in militaristic argumentations. These do not dispute the huge sacrifices that wars usually claim. But they argue that these sacrifices are necessary since only the hardships of war provide incentives for human beings to accomplish extra-ordinate achievements. If war was to cease, humanity was to wither in limpness, they argue<sup>2</sup>.

The liberal view put forward by von Mises strongly rejects this interpretation, too. Instead, he argues that the source of progress is not to be found in war, but in peace. The progress of mankind is based on fruitful cooperation that enables men to specialize in their endeavours. This specialisation process can only occur during peaceful times when people do not have to fear being stripped of their legitimate property rights by brute violence. In times of war, entrepreneurs do not dare to specialize and thereby have to forgo the profits of division of labour. Thus, wars always lead to outcomes that are inferior to the state of prosperity that can be reached in times of peace. Hence, even the state winning the war will eventually be worse off than if he had not gone to war at all<sup>3</sup>.

The war between Russia and Georgia has sparked exactly the repercussions liberal thinkers like von Mises predicted. After the war the Russian stock markets plummeted. This is of course also due to the turmoil at the financial markets worldwide, but the Russian stock markets did far worse than those of other emerging economies like Brazil<sup>4</sup>. Furthermore, the downturn of the Russian markets started earlier and proved to be sharper now amounting to a loss of about two thirds compared to its peak in May.



... or Loser?

The Russian Stock Market Trend from May to November 2008

This impressive decline of the Russian stock markets is clearly linked to the war in Georgia. Since about half of the so-called free-float - the liquid portion of the stocks in the market - is held by foreign investors, the courses are sensitive to political risks<sup>5</sup>. In addition to the foreign investments in stock markets, Russia is also highly dependent on direct foreign investments in its industry. But in the aftermath of the war in Georgia, about \$20 billion have flowed out of Russia in August only. Until now, it is estimated that up to \$40 billion in foreign investments have been withdrawn from the Russian economy<sup>6</sup>.

In recent years, Russia has run high-surplus budgets due to the exploding oil prices and invested its money in contingency funds totaling up to \$190 billion. But Russia has to spend heavily to compensate for withdrawn foreign investments, to provide its major banks with liquidity and to halt the impressive downturn of its stock markets. This fuels the impression that even the massive wealth of the contingency funds could melt away rapidly in times of financial crisis. In fact, the Russian monetary reserves have shrunk by more than 10% within two month only<sup>7</sup>. If all hidden reserves are taken into consideration, the Russian wealth amounts to an impressive figure of €400 billion even. But this big picture does not make Russia's situation look better. Indeed, if, in addition to the hidden funds, all hidden state investments used to stabilize the financial sector are taken into account, Russia had to spend a staggering €150 billion<sup>8</sup>. The war in Georgia was definitely not the only contributing factor to the massive crisis of the Russian economy, but it drastically accelerated its negative developments.

These, in turn, have triggered a counter-reaction by the Russian political elites. Dmitry Medvedev, President of the Russian Federation, re-emphasized that Russia would stay committed to provide a business friendly environment to both domestic and foreign investors. He advocated a policy of mutually beneficial cooperation

between Russian and Western enterprises<sup>9</sup>. On September 19<sup>th</sup>, during an economic forum in Sochi, other senior decision makers like Vladimir Putin reiterated that Russia was dedicated to a business friendly policy.

But as long as Russian politics do not comprehensively signal long term commitment to live up to the Western standards, it is unlikely that investors will be willing to transfer their money into a country that does not fully respect property rights, as the war in Georgia has demonstrated<sup>10</sup>.

Andrew Brown, portfolio manager specializing in emerging market equities for Aberdeen Asset Management, emphasized that he was not willing to invest in Russia. Instead, he recommended investments in Mexico, Brazil and India, since the political risk was too high in Russia. The risks for shareholders in Russia were “systemic, not situational“, he said<sup>11</sup>. This impression has been fuelled by the current events in Russia. Alain Bourrier, senior portfolio manager who runs an emerging markets fund at BlackRock, stated that “clearly, Russia does not look good in the Western eyes with the Georgia operation“<sup>12</sup>. As long as Russia does not fundamentally change its policies towards genuine support of a market economy, it can not expect the ambitious words of its leaders to yield any fruitful results.

In early October 2008, Russia presented its economic long term plans for the period until 2020. This ambitious document sketches ways for improving trade, investment and economic cooperation. But the most important pillar of all the options presented remains closer cooperation with the West<sup>13</sup>. The unnecessary and excessive handling of the Georgian crisis by the Russians questions this approach heavily.

If Russia wants economic cooperation, it should be supported in its efforts, but only, if it accepts the Western terms of international cooperation. This means, first of all, undoing the political turmoil the Russians have caused in the Caucasus region. But if it fails to cooperate politically, it should be denied economic support. Russian leaders have to understand that economic and political spheres cannot be conceived as separated and that it is not possible to choose cooperation in one field and confrontation in the other. If Russia wants full-fledged cooperation it can have it, otherwise it can not expect Western benevolence. Eventually, it is Russia's turn to choose the means of interaction.

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- <sup>1</sup> Von Mises, Ludwig 1927: Liberalismus, Jena, p.20
- <sup>2</sup> Von Mises, Ludwig 1927: Liberalismus, Jena, p.20f.
- <sup>3</sup> Von Mises, Ludwig 1927: Liberalismus, Jena, p.21
- <sup>4</sup> Levy, Clifford J. 2008: Stock slump imperils Putin's legacy, in: International Herald Tribune, 13.10.2008, <http://www.iht.com/articles/2008/10/13/europe/13russia.php>, recalled: 29.10.2008
- <sup>5</sup> Kramer, Andrew E. 2008: Russian markets fare worse than most, in: International Herald Tribune, 5.9.2008, <http://www.iht.com/articles/2008/09/05/business/ruble.php>, recalled: 29.10.2008
- <sup>6</sup> Oxford Analytica 2008: Ukraine: Prospects for inward FDI worsen, in: International Herald Tribune, 25.9.2008, <http://www.iht.com/articles/2008/09/25/news/25oxan-ukraine.php>, recalled: 29.10.2008
- <sup>7</sup> Willershausen, Florian 2008: Finanzdesaster in Russland - Krisenmanagement nach Kreml-Art, in: Der Spiegel, 12.10.2008, <http://www.spiegel.de/wirtschaft/0,1518,583378,00.html>, recalled: 29.10.2008
- <sup>8</sup> Willershausen, Florian 2008: Finanzdesaster in Russland - Krisenmanagement nach Kreml-Art, in: Der Spiegel, 12.10.2008, <http://www.spiegel.de/wirtschaft/0,1518,583378,00.html>, recalled: 29.10.2008
- <sup>9</sup> Shchedrov, Oleg 2008: Medvedev denies Russian economic crisis, in: International Herald Tribune, 15.9.2008, <http://www.iht.com/articles/reuters/2008/09/15/america/OUKWD-UK-RUSSIA-MEDVEDEV.php>, recalled: 29.10.2008
- <sup>10</sup> Kramer, Andrew E. 2008: Russian markets rebound, in: International Herald Tribune, 19.9.2008, <http://www.iht.com/articles/2008/09/19/business/ruble.php>, recalled: 29.10.2008
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- <sup>12</sup> Story, Louise 2008: War heightens Wall Street's concern on Russia, in: International Herald Tribune, 15.8.2008, <http://www.iht.com/articles/2008/08/15/business/ruble.php>, recalled: 29.10.2008
- <sup>13</sup> Charap, Samuel 2008: As Markets Tumble - Russia's peace offensive, in: International Herald Tribune, 13.10.2008, <http://www.iht.com/articles/2008/10/13/opinion/edcharap.php>, recalled: 29.10.2008