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# Without EU Cash, Russian Business Is Sunk

By Mark Adomanis

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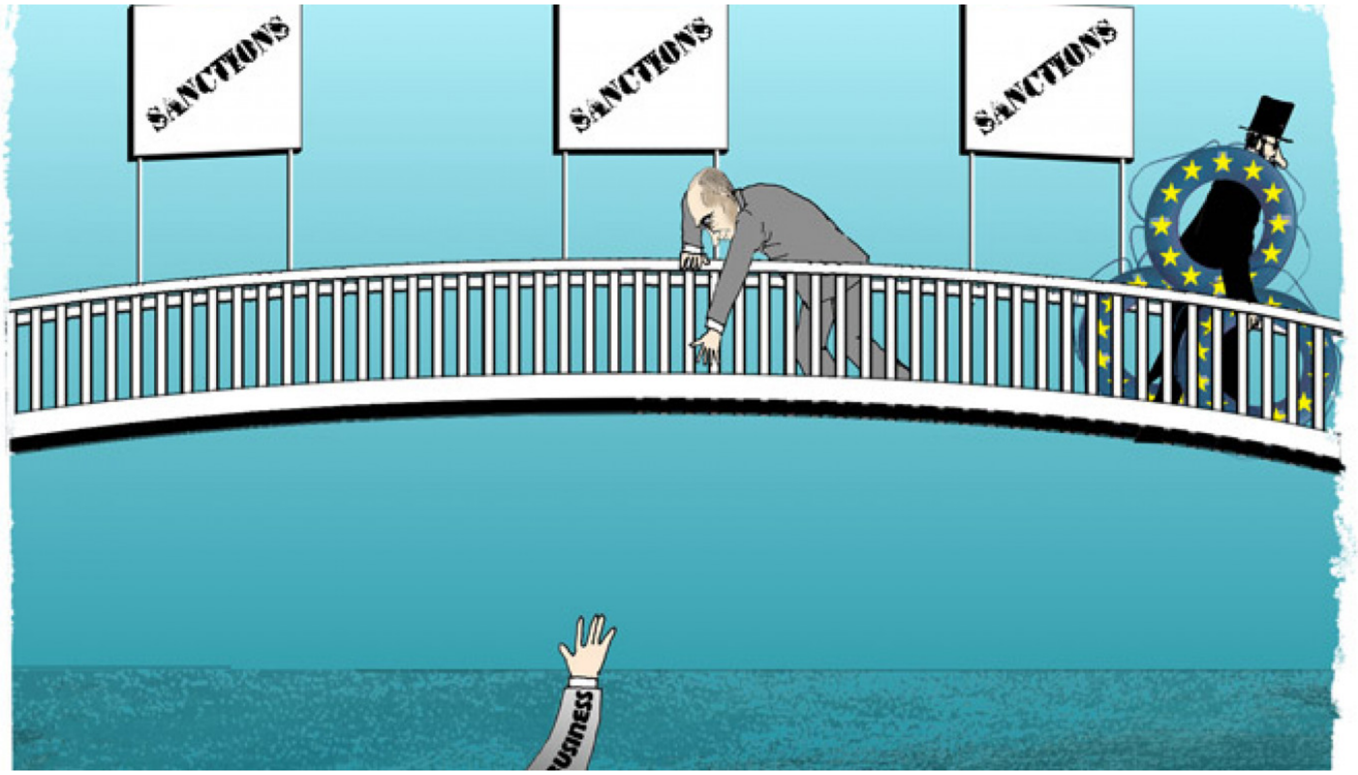


Before the downing of Malaysia Airlines Flight MH17, it was hard to see how the Europeans were going to implement serious economic sanctions against Russia. But the shooting-down of a civilian airliner has been a political game-changer and has rapidly pushed formerly reluctant countries like Germany and France to a position that was widely considered impossible not even a full month ago.

It is possible, of course, that the Europeans will lose their nerve. Stranger things have happened than the European Union changing course at the last minute, and nothing prevents the sanctions from being softened a week, a month or, God forbid, even a year down the line.

Given the political reality, however, and the Russian government's continued and loud insistence that it has nothing to apologize for, it now seems probable that Russia will be faced with a sanction regime for the short and medium terms. I'd like to forecast a reduction in tensions in Ukraine because that country has suffered enough already. But over the past five months, every time it appeared that things had finally started to get better, they rapidly relapsed.

So what will the sanctions do? The consensus view among most economists is that they will be a serious, if not catastrophic, problem.

In particular, Western analysts express broad agreement that the latest sanctions will substantially limit Russian companies' ability to borrow and will make that borrowing much more expensive. After all, it is hard to structure a deal when no one knows whether the bank funding it will soon be on a Western blacklist.

The Russian finance sector is largely at a standstill already, a combination of the sanctions themselves and the pervasive uncertainty they have inspired. Russia has benefited greatly from its ability to access long-term credit in Western financial systems, particularly London, and that access is now sharply constrained.

Many people — particularly those who work in, or are sympathetic to, the Russian government — argue that the sanctions will actually help Russia by forcing it to more intensively develop certain areas of its economy.

Foreign Minister Sergei Lavrov, as usual, provided a clear and concise formulation of the official position: "We will overcome any difficulties that may arise in certain areas of the economy, and maybe we will become more independent and more confident in our own strength."

President Vladimir Putin has gone even further, publicly stating that Russian defense procurement should be an entirely domestic affair and that Russia should "do everything" to ensure that it does "not depend on anyone in any of the areas of the army and fleet rearmament."

"Import substitution" is the latest buzz phrase coming out of the Kremlin, and if sanctions continue to be imposed for any significant length of time, I expect that the Russian authorities will actually try to implement such a policy.

But here's the problem: It won't work. The list of countries that have successfully conducted a policy of import substitution is much shorter than the list of countries that lapsed into pervasive economic stagnation. When the Kremlin thinks "import substitution," it imagines becoming the next South Korea or Taiwan: innovative, dynamic and world-class. The more likely outcome is Argentina: lethargic, overly expensive and anachronistic.

It is theoretically possible, of course, to stimulate domestic production by limiting the availability of foreign goods. If you don't let Russians import chicken legs from the U.S., so the thinking goes, someone will eventually build a poultry plant and produce them in Russia.

To work properly, though, a policy of import substitution requires a liberalized and flexible domestic economy and an efficient, transparent and noncorrupt government. Only with these conditions can truly competitive firms emerge to fill the gap left by foreigners. Otherwise you end up with politically connected and inefficient firms that produce goods that, in comparison with the world market, are too expensive for their actual quality. In other words, if you try import substitution and don't pull it off, you end up with a perfect recipe for economic stagnation.

There's a reason that Russia has gotten so much wealthier over the past 15 years, and it is not because it made any attempt to limit the use of foreign goods. Indeed Russian imports have exploded as the economy has grown, and the increasing ability of Russian consumers to access high-quality foreign goods has been an enormous boon for the society as a whole.

Russia attracts quite a lot of scorn and derision for its resource-dependence, but in comparison to other countries it appears to genuinely possess a comparative advantage. There is nothing wrong with selling oil and using the proceeds to buy German machine tools. Indeed it is exactly what you'd expect given Russia's history and its current level of development.

The almost uniform failure of other countries' attempts at import substitution, and an honest look at Russia's political and economic institutions, suggests that any large-scale attempt to replace foreign goods with Russian-made analogues will fail.

This isn't certain, of course, but it is hard to come up with an explanation of why Russia would be an exception to the trend. It would be nice to think that Western sanctions will have some kind of silver lining, but it is far more likely that they will further weigh on a Russian economy that doesn't need any more problems.

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