

Too Many Bad Loans In China?

By Paolo von Schirach

March 14, 2014

WASHINGTON – Until very recently a large number of Western analysts bought the idea that China created a unique, unprecedented, in fact almost gravity-defying growth model. Its economy is recession proof. And (until very recently) it kept growing and growing at a fantastic 10% rate, year after year, without suffering any of the traditional ailments experienced by its (inferior?) Western counterparts. China had no boom and bust. No inflation or deflation issues. Even though the pace has slowed a bit (from 10% to 7.5%), China keeps investing and it keeps growing. The conclusion reached by many is that the super smart Chinese technocrats, carefully selected and groomed by the ever provident and wise Communist Party, have invented something new, and quite superior.

China's export-led economy worked well

Well, may be all this optimism was a bit exaggerated. The fact is that China did extremely well until it could expertly exploit unique domestic advantages, most of them resting on abundant, obedient and super cheap labor and on the ability of the state-owned banks to direct mountains of captive private savings pretty much where they wanted.

The export-led model, supported by the rapid modernization of all infrastructure enabling international trade, worked spectacularly well. Amazingly cheap Chinese products, the net effect of cheap labor, destroyed many Western competitors. Chinese manufactures supplied fantastic quantities of basic consumer goods (anything from toasters to T-shirts, vacuum cleaners, toys or silverware) to millions of Americans and Europeans at rock bottom prices. Export markets

grew and grew.

The magic is fading

But now the magic has started to fade. Export markets are saturated. They cannot grow by 10% a year, every year. And Chinese labor is not so cheap any more. Wages are going up in China, therefore Chinese goods are no longer super competitive. And in sectors in which labor costs are less relevant most Chinese products (there are exceptions) have few, if any, built-in advantages in terms of superior quality, innovation or design.

Oversized shadow banking

That said, there are other problematic factors. Much of the (now somewhat declining) Chinese growth in recent years has been fueled by oversized investments financed via massive debt. And much of this debt now is held by a growing shadow banking sector that is largely opaque and unregulated. ***Indeed, as The Financial Times reports, China's shadow banking is valued at \$ 7.62 trillion. Yes, that is trillion. This amounts to almost half the value of US GDP.***

The emerging concern, now bordering on fear, is that a significant part of the credit extended through shadow banking may consist of bad and therefore unrecoverable loans. Indeed, one leading US market analyst said recently that "*China is a disaster waiting to happen*". Indeed, it would appear that much of the bad debt is the result of excessive lending to saturated sectors already plagued by overcapacity, such as steel.

Imagine this scenario: many Chinese companies go bust causing shareholders losses, shadow banks that lent them money fail, this way ruining investors, while untold numbers of workers are suddenly unemployed, with no place to go because the economy is not expanding anymore as it used to.

Bankruptcies

A little bit of unraveling just started. Chaori Solar, a relatively small solar panel maker, failed to pay the interest on its bonds. This is the very first time in modern history that China experiences a corporate bond default. And then there is the failure of Haixin Steel.

Now, a couple of defaults in the second largest economy in the world certainly are not enough to create a disaster. Except that this is new in China. In the past, the state would have intervened to save companies. Now it decided not to. The benign interpretation is that (once again very wisely) the Chinese government decided that it is good to purge the system.

Just dead wood?

In fact, in what appears as an attempt to stay ahead of events, Li Keqiang, China's Prime Minister, publicly stated that going forward a few more bankruptcies are inevitable, and indeed expected. The message is: *"Do not worry. We know this is coming; and we shall manage these events so that they will not cause any contagion"*.

Some speculate that this new hands-off policy is part of a "detox therapy" that will make China stronger in the long run. Let a few rotting apples be expunged from an otherwise healthy economy. This would be good, in as much as it will eliminate dead wood, while reminding corporations and investors about their responsibilities in properly assessing risk. If it were indeed so, then nothing to worry about. China's vast economy can easily absorb a few bankruptcies.

What if it is worse than we think?

But some analysts worry. The enormous shadow banking system is largely unregulated. What if the percentage of bad loans is much higher than what the optimists estimate? What if over

investments led to massive over capacity in multiple sectors, bound to be followed by a wave of bankruptcies? What about the possible cascading effects of such bankruptcies on the finances of local governments? What about new unemployment caused by factories closing down?

Many of these dire (but not impossible) scenarios are based on speculation. The Chinese authorities do not release much reliable information. Official statistics are notoriously manipulated. Notwithstanding a large and growing private sector, much of the economy is still managed by a relatively small and secretive group of technocrats. They do not operate in a transparent system.

Therefore, while we understand that now there are “problems”, some of them quite novel in a Chinese context, we simply do not know how big and how serious they are.

Well functioning economies thrive in free societies

All this leads me to a general consideration. China’s “*dirigiste*”, statist economic development model, with its almost statutory top-down management, worked extremely well for almost 30 years. An impressive, in fact unprecedented, record.

But now this model is inadequate. In order to go to the next level, the level of vibrant, bottom-up innovation led by real entrepreneurs relying on modern capital markets, China has to change. There has to be transparency and accountability within a rules-based system that operates according to internationally recognized best practices.

China is not about to announce political reforms

But such a shift to openness and decentralization would be possible only if preceded or accompanied by real political liberalization. And I do not see signs of any such reform process unfolding.

My simple point is that a modern economy grounded on innovation leading to global technological competitiveness can exist only in a context of genuine political freedom. China's self-appointed technocratic leaders may try to manage the ever more complex system they created.

But they may not succeed.

Ukrainian Prime Minister Yatsenyuk Both Defiant And Conciliatory In A Speech At The Atlantic Council

By Paolo von Schirach

March 12, 2014

WASHINGTON – The Western world seems to be united in its support for the embattled (and truly broke) Ukraine. Regarding the unprovoked Russian invasion of the Crimean peninsula, The G 7 issued a statement indicating that territorial changes in the Ukraine arrived at without following the proper constitutional process will not be recognized: *“Any such referendum [on the secession of the Crimea] will have no legal effect”*. The EU, on its part, also condemned the Russian military occupation and Moscow's moves aimed at the annexation of the Crimea.

Obama's support

President Obama added his open support when he received at the White House Arseniy Yatsenyuk, the Ukrainian Prime Minister,

on March 12, just days prior to the planned referendum on joining Russia to be held on March 16 in the Crimea now under Russian military occupation (in violation of the Ukrainian constitution). So, the message to Putin is clear: *“We, Europe and America, stand firmly with the new government in Kiev. What Russia has done is unacceptable. Moscow has to order its troops to go back to their barracks”*.

Prime Minister Yatsenyuk at the Atlantic Council

The young (39 years old) and affable Prime Minister Yatsenyuk, speaking at a packed event hosted by the Atlantic Council, a prestigious, non partizan Washington foreign policy think tank, talked confidently about all the support his country has received.

And yet, the general tone in the West, and even in the words articulated by the Prime Minister, is not bellicose. Yatsenyuk opened his remarks at the Atlantic Council referring to the Russians as past and future “partners”. He repeatedly indicated that this unprecedented crisis created by the invasion should be resolved through dialogue and diplomacy. He pointed out that the Ukrainian government is eager to work on new laws and regulations that will further enhance the autonomy of the (mostly Russian speaking) Crimea. He pledged that there is and there will be no discrimination in the Ukraine against the large Russian minority.

Autonomy to the Crimea

In other words, he *almost* said (anyway this is what I read between the lines) that the Ukraine is willing to give the Crimea *virtual* (even though not legal) independence. (Any formal secession could be arrived at only by following a prescribed constitutional process).

Yatsenyuk did everything he could in his remarks at the Atlantic Council to reassure the Russian government in Moscow, the Russians in the Crimea and in the rest of the

Ukraine that they have nothing to fear. The government in Kiev does not and will not discriminate against anybody.

Which is to say that if indeed the Russians have intervened militarily because of a genuine concern about the welfare of the Russians in the Crimea, *there is really no issue*. The Ukrainians are committed to protecting all citizens equally, regardless of ethnicity.

The Russians can get reassurances

If the Russians have indeed acted in good faith, out of fear about the fate of their brethren in the Ukraine, then they should seize this opportunity and start a dialogue with Kiev aimed at spelling out how the Russians in the Crimea and elsewhere in the Ukraine will be protected by the new government.

If this were indeed the real issue, then it could be addressed and solved, since the Ukrainians, according to the Prime Minister, are willing to concede (almost) *everything* when it comes to additional autonomy to the Crimea. Yatsenyuk pointed out that this would not require a major effort, as there was no violence or discrimination against ethnic Russians in the Crimea prior to the Russian military occupation.

The alleged persecution of Russians is just an excuse

The problem is that Putin used the alleged persecution of ethnic Russians in the Ukraine as a convenient excuse. I doubt that he believes any of what he said publicly to justify Russia's military intervention. The fact is that for his purposes of power consolidation and reaffirmation at home, seizing the Crimea after having lost (politically) the Ukraine seemed the clever thing to do. This notion of "saving" oppressed Russians unjustly separated from the Motherland has a certain ring among Russian nationalists, and so this was a politically astute move. In Russia and among most Russians, Putin now looks very good.

But Putin is now in a bind abroad. The West is against all this. There is no way that an open land grab that violates key principles of international law, along with a multilateral treaty that guarantees Ukrainian sovereignty co-signed by Russia, can be ignored. Berlin, London and Washington simply cannot continue business as usual with Moscow.

What will the West do?

That said, it is unclear to me, despite the declared support for the Ukraine, what exactly does the West plan to do. Are we ready to go to the next level: ***namely serious economic sanctions against Russia?*** We certainly could, starting with the seizure of bank accounts and properties owned by the Russian oligarchs (most of them friends of Putin) who have stashed their loot in London and Geneva and who bought luxury homes in Paris or the Riviera.

Sanctions, anybody?

We could really hit Russia where it hurts. And let's remember that Russia does not have a lot of staying power. It has a relatively weak economy that is almost totally dependent on the revenue provided by selling oil and gas abroad.

Of course, there are also clear European vulnerabilities. The Russians know that Europe depends on Russia's gas. Therefore, if Europe freezes economic relations with Russia, and gas stops flowing west, what will happen in Germany or Poland? How will they keep the lights on without Russian gas? No easy answer for this, as there is no immediate alternative to Russian gas. This energy dependence makes it very unlikely that Germany, Sweden or Bulgaria are prepared to enforce really tough economic sanctions against Russia.

In the US the picture is only marginally better. (By the way, we have all the gas we need here at home). President Obama, notwithstanding his recent show of support, has no special interest in prolonging a foreign crisis that most

Americans do not even begin to understand, just a few months before the November congressional elections in which his party already stands to lose a lot of seats.

Putin's calculations

All in all, my sense is that the Russian "Crimea Gamble" included the calculation that there would be no Western united front against Russia. If this is so, Putin may really believe that he will get away with this unprecedented land grab.

I would love to be wrong on this, but I suspect that Putin's assessment is correct. There will be a split within the West. If Putin is right, in the end he will prevail. He is a bully willing to take risks. The "peace-loving" Europeans are not in the same league.

Western verbal support

For the moment, everybody is saying the right things. But when it comes to "**action**" I suspect the music will change –a lot. The poor Ukrainians will realize that they are pretty much on their own on the Crimea.

They will get (some) money from the EU, the US and the IMF to stabilize the economy, and more help down the line for structural fiscal and institutional reforms. But nobody is going to engage in serious, prolonged actions –let alone military actions– against Russia, in order to restore law and order in the Crimea.

Without real (as opposed to verbal) support, the Kiev government will have to settle. It is obvious that the Ukraine cannot afford to be in a state of permanent crisis with Russia. There are just too many intertwined interests, too many relationships. Eventually some face-saving formula regarding the final status of the Crimea will be devised.

The world will nod and we shall all move on.

A New Balance Of Power When America Will Start Exporting Gas

By Paolo von Schirach

March 11, 2014

WASHINGTON – If America were capable of exporting oil and gas, the geopolitical situation in the Ukraine and in Europe would look a lot different. Today Russia has leverage because it is a critical supplier of natural gas to the Ukraine and to several European countries. The Europeans do not want to get into a confrontation with Russia over the Crimea because it is dangerous to get into a bad argument with your main energy provider. But if the same countries got some or most of their energy from the US, then Russia would have far less or even zero leverage.

US as energy exporter?

Until just a few years ago the notion that America, the world main oil importer, could become a net energy exporter would have appeared crazy. Not so anymore. Due to increased domestic production and higher efficiencies, the US is importing much less oil. In the not so distant future it will depend only on imports from the Western Hemisphere (mostly Canada). And when it comes to gas, soon enough the US will be able to export Liquefied Natural Gas, (LNG).

Energy security is good

Imagine for a second what difference it would make if today

the US were able to deliver LNG to the Ukraine, now totally dependent on Russian supplies. This would be a game changer.

I have been arguing for years in favor of US energy policies that would increase America's energy security, while allowing the US down the line to become a net energy exporter. It should be self-evident that in this complicated and conflict-ridden world America should not be hostage of (critical) energy supplies from distant and potentially hostile sources. By the same token, it would be reassuring for America's allies if the US were in a position to meet at least some of their energy needs. Increasing the sources and the amounts of supply would make disruptions (and blackmail) less likely.

No US energy policy

In the US, the energy picture is steadily improving. But this is not the outcome of well crafted policies. Sadly, America has no energy policy. The positive developments we are witnessing are (luckily) the result of private sector-led efforts and favorable geology. Simply put, the stuff is there and smart people know how to get it.

Driven by the old-fashioned American hope to make money, US energy companies devised new technologies –hydraulic fracturing (fracking) and horizontal drilling– to extract fossils fuels in a cost effective-way. Hence the amazing shale gas and shale oil revolutions that have literally transformed the world energy map. Yes, today America has more gas than Russia.

A few more things could be done

This is great. Now America is much more energy self-reliant, and this trend is going to get even better as we move on. But we could go even faster. There are a few relatively easy things that could be done now. They are blocked only by partizan politics.

- First of all, the Obama administration should authorize the construction of the TransCanada Keystone XL pipeline. As we still import oil, it would be a lot better to get more of it (about 800,000 barrels a day) from friendly Canada, as opposed to sourcing it from the Persian Gulf.
- Then the administration should allow the extraction of oil from Alaska. Again, this would mean more domestic oil, and lower imports.
- Washington should send a clear signal to US gas producers by stating that the Federal Government will now buy heavy trucks fueled by LNG. The reason for this is simple. We have plenty of cheap natural gas. If we could use it also as transportation fuel, (beyond power generation and heating), this switch to domestic (cheaper and cleaner) energy would reduce imported oil by almost 3 million barrels a day, assuming a total switch involving all US heavy trucks.
- At the same time, assuming the continuation of all this natural gas bonanza, Washington should authorize the construction of additional LNG terminals, so that America could export some of its natural gas.

Reduce Russia's Leverage

As I said at the beginning, Russia's leverage in Europe would not be the same if today America were an energy exporter. By the same token, the power and influence of countries like Iran or Venezuela would be reduced or nullified once their leverage as major energy exporters is reduced.

Once again, think about the relations between Russia and the Ukraine and Russia and Europe today and what they could be the day in which America starts exporting its natural gas to Europe.

I believe that, even without ascribing benign intentions to America's energy companies, (they are motivated by their

desire to make money), the Ukrainians and the Germans would rather depend on Chevron than on Gazprom.

Financial Aid To The Ukraine? Great Idea But Huge Costs

By Paolo von Schirach

March 10, 2014

WASHINGTON – A few days ago, I argued [in a related piece](#) that it is hard to believe how Ukraine can be considered by either Russia or the West as a coveted prize in this emerging new version of an East-West confrontation. The country is vast, (almost the size of Texas), and it is home of a fairly large population, (somewhere around 45 million). Other than that, however, Ukraine is a real mess. It is poorly organized, very corrupt and essentially broke. Indeed, just to get things back together, we are talking about [a \\$35 billion bill](#). I assume that includes all the unpaid natural gas bills that Ukraine owes Russia's Gazprom.

Save the Ukraine?

And yet, notwithstanding this economic train wreck, now the talk is about the (semi-broke) West bravely stepping up to the plate in order to “save” Ukraine. Indeed, if I understand correctly the still hazy plans articulated by US Secretary of State John Kerry and some European policy-makers, we are in for a lot more than just an emergency financial rescue operation.

We are talking about a long-term commitment to turn the

Ukraine around.

We are talking a major, multi-year assistance package, (including money, tools, technical expertise), aimed at helping the new leaders of the courageous Maidan demonstrators in planning and then implementing major reforms. The goal is nothing less than a reborn Ukraine that would prove to the world (and of course to its Russian neighbors) that a messed up, post-Soviet Republic can become a viable, modern country by adopting best practices when it comes to ensuring basic freedoms via good governance and the adoption of sound economic management. In a nutshell: if we are serious about this, we are talking years and years of sustained work, and tens of billions of dollars.

This is going to be expensive

Turning the Ukraine around is of course a great idea. The problem is that, even assuming good will and not too much negative Russian interference, (you can count on Moscow's attempts at sabotaging pro-Western policies), this is going to be difficult and very, very costly.

Therefore, Western leaders should make this very clear. For instance, I am not sure that US voters, worried about unemployment, stagnant wages and massive student loans debt burdening millions of young workers are that keen on pouring billions of dollars into the Ukraine mess.

Let's try

That said, I do hope that America and Europe, with the support of the IMF and others, will try this. If the Ukraine succeeds, if it becomes like Poland, a former Communist country that successfully embraced Western values, this would strengthen Europe and America. Furthermore, it would show the world that our model works. Yes, a well-functioning democracy is the

foundation for sustainable prosperity.

Nation building? Again?

Look, I realize that here in the US any undertaking that even remotely resembles “*nation building*” evokes the truly bad experiences of Afghanistan and Iraq. And for very good reasons. Lacking judgment and even elementary common sense, the Bush administration and to a lesser extent the Obama administration poured tax payers’ money into costly and generally ill-advised development assistance projects aimed at these two countries. The US “Grand Strategy” at the time of the Bush administration was to crush dangerous tyrants and autocrats, have free elections so that the people would finally have a say, and then help the new, democratically elected policy-makers rebuild their countries following the tried and tested Western model. And so, thanks to America, there would be genuine freedoms, market economies, no more corruption, gender equality –and a lot more. Yes, people would vote, children would get immunizations, girls would go to school. A New World.

Nice and noble ideas. But it could not be done. Not because the aims were bad, but because there was a gigantic disconnect between the lofty goals on one side and the relatively small resources allocated, plus the (almost insane) belief that much could be done in a relatively short period of time on the other.

It could not be done

Simply put, you cannot have gigantic social and economic transformations –premised on new values being genuinely embraced by millions– in a matter of a few years. At the time of the US military occupation in 2001, Afghanistan was a semi-destroyed country with almost no viable economic activities. Thanks to the Taliban, it lived virtually in the

Middle Ages. It was disconnected from the rest of world.

The very fact that some people in Washington embraced the notion of a turbo-charged modernization program as a viable proposition is baffling. And that approach, mind you, was developed before the rebirth of the Taliban-led insurgency made everything a lot more difficult.

Ukraine is different

Well, if we fast forward to today's Ukraine with the still fresh memories of the Afghan and Iraqi failures in our minds, the idea of starting all over along the same path looks really unpalatable. And for very good reasons.

The huge difference, though, is that the Ukraine, while in truly bad shape, is a semi-modern country. It has educated people and some of the building blocks to make things work. Therefore we can assume that our chances of success would be a lot higher. And, again, let's keep in mind that helping to build a viable society in a vast country at Europe's immediate periphery in the long-term would help peace and stability in the Continent.

Uncertain mission, but worth pursuing

That said, if America and Europe are serious about this undertaking, we are talking about tens of billions of dollars over a number of years. Beyond the immediate financial crunch, the Ukraine will need investments and help to modernize its industries, its infrastructure, its governance, its education systems, and what not. And, let's not forget that this noble attempt may fail. If the country will not abandon its deeply rooted culture of corruption nothing much can be done.

Still, even keeping in mind the lessons of Afghanistan and

Iraq, and the uncertainties embedded in any undertaking of this magnitude, the Ukraine is a far better place. And the stakes for the West are arguably much higher.

Vladimir Putin's dream is to bring major pieces of the old Soviet Union back into the fold. But he has nothing good to offer. Beyond oil and gas, Russia is not a leader in anything. Whereas Europe and America can offer a new path to democracy and prosperity (via investments, technology transfers and trade) to the Ukrainian people.

And ultimately it is in our own self-interest to demonstrate that our values and our systems really work. This is the best lesson that we can offer to all the people who suffer under autocratic regimes, in Russia and elsewhere:

Democracy is the right choice, and it is really good for you.

With A Forced Referendum On Joining Russia, The Crimea Crisis Gets Worse

By Paolo von Schirach

Related story:

<http://schirachreport.com/index.php/2014/03/05/ukrainians-willing-grant-additional-autonomy-crimea-translation-crimea-lost/>

March 7, 2014

WASHINGTON – I recently argued (see *link to a related story above*) that the Crimea “is gone”. I pointed out that Russia

does indeed have a case for obtaining a “special status” for the (mostly Russian) Crimea. I thought that the easy way to get to a “*de facto*” Russian Crimea could be a constitutional arrangement agreed upon by the new government in Kiev whereby the Crimea will become even more “autonomous”. This arrangement would be “*de facto*” independence. This way everybody (so to speak) would be satisfied.

De facto independence for the Crimea

The Russians, by exerting pressure, would get most of what they want. The Ukrainians would save face because they would maintain nominal sovereignty over the Crimea. The international community (Europe and NATO countries in particular) would note that there has been no change of international borders on account of military actions.

I argued a few days ago, and I still argue today that this path to a diplomatic “solution” was wide open.

I also added that this forced constitutional change within the Ukraine would set a bad precedent, in as much it would have occurred because of military pressure. However, i thought that –unless we are ready to move into an open US-Russia military confrontation over the Crimea– this would be the least damaging outcome.

Victory

Well, it looks as if Putin is not satisfied with the idea of getting what he wants through a diplomatic settlement.

He wants “victory”.

If this were not so, it would be impossible to explain Russia’s decision to force an immediate referendum to be held in the Crimea, in a matter of days, in order to have a formal secession of the Crimea from the Ukraine so that the region would immediately become part of Russia. As I said above,

Putin could have obtained most of this by agreeing to a formula that would have granted “*de facto*” independence to the Crimea, even though the Ukraine would have kept nominal sovereignty over the region.

Now it gets a lot more complicated

But now –with this forced referendum to be held in just a few days– all this gets a lot more complicated. While nobody doubts that many if not most of the ethnic Russians in the Crimea may indeed prefer to become part of Russia, the fact that this unprecedented change of internationally recognized borders happens while the Crimea is under Russian military occupation, (by the way the Russians deny this, claiming that all those soldiers are local volunteers), invalidates any idea of people exercising their sovereign right to self-determination.

Sanctity of borders

Even the mostly timid Europeans would have a hard time swallowing this forced secession. Let’s remember that the basic principle of post-WWII European security is the sanctity of borders.

Indeed, if you are in Estonia, Latvia or Lithuania, independent Baltic States with sizable Russian minorities within them, the implications of the forced incorporation of the Crimea into Russia, if the rest of Europe decided to look the other way, are very obvious: “*We may be next*”. If indeed Putin wants a referendum in the Crimea that most countries would have to denounce as invalid, then getting to a peaceful resolution of this crisis, with all parties reasonably satisfied, becomes a lot harder.

Another miscalculation?

Or may be Putin, this time probably miscalculating, believes that Europe will do nothing, while America (as always) is all

talk and no action?

In other words Putin may truly believe that, even as his behavior becomes more and more outrageous, he can get away with it because the decadent West has no strength to resist him.

No need to repeat here that many unnecessary conflicts originated in such miscalculations.

Ukrainians Are Willing To Grant “Additional Autonomy” To The Crimea – Translation: The Crimea Is Lost

By Paolo von Schirach

March 5, 2014

WASHINGTON – I [recently wrote](#) that Vladimir Putin, come what may, will not relinquish the Crimea. Nothing that has happened so far has made me change my mind. Putin may pay a price for this act of unprovoked aggression. However, if he plays his hand cleverly, may be there will be no price.

No annexation, but control

Putin does not have to proclaim the annexation of the Crimea. This would look bad. It is enough for him to demand that the Crimea (inhabited mostly by ethnic Russians) will be able to enjoy a higher degree of autonomy from the rest of Ukraine.

The Russians, of course, will retain their naval base in the Crimea on the basis of existing agreements. For all practical purposes, the Russians will control the Crimea. But the peninsula will remain a part of Ukraine, at least formally.

Ukrainians willing to consider “additional autonomy”

A hint of this likely development comes from the provisional Ukrainian government in Kiev. Mr. Arseniy Yatsenyuk, acting Prime Minister while the country gets ready for new elections, indicated in a press conference that he is [open to discussing a new status for Crimea](#). He said that Kiev is ready “to consider what kind of additional autonomy the Crimean Republic could get”. So, he has already conceded defeat. “Additional autonomy” will be in practice virtual independence. (Even before this crisis the Crimea enjoyed some degree of autonomy, in recognition of its history and different ethnic composition. Most of the people there are Russians. Indeed, Crimea used to be part of Russia proper until 1954, when it was “reassigned” to Ukraine by Nikita Khrushchev.)

So, the Crimea, for all practical purposes is gone. Putin prevails.

Nobody will fight for the Crimea

Ukrainians cannot win this one. Clearly, while America and even the EU are willing to shore up Ukraine proper, nobody is going to go to war with Russia for the Crimea, a region of Ukraine inhabited mostly by ethnic Russians.

In the end, as long as the virtual detachment of the Crimea from the rest of Ukraine is officially described as “greater autonomy” in the context of a “federation”, who can complain? Ukrainians are likely to agree, even though they will know exactly what this “additional autonomy” means: they lost the

Crimea.

The Russians will express satisfaction with a new arrangement that guarantees the safety and welfare of their brethren in the Crimea.

The Russians win

The international community, with Washington in the lead, will also say that all is well, because Ukrainian sovereignty has not been breached, and Ukrainians got to decide a new arrangement on their own.

But, in the real world, everybody will know the truth. Putin's thuggish action paid off. He gets away with a piece of Ukraine. It will be not be Russian in a technical, legal sense; but the whole world will know who is in command there.

With Or Without A Major Crisis In The Ukraine, Putin Determines The Agenda

By Paolo von Schirach

Related piece:

<http://schirachreport.com/index.php/2014/03/03/ukraine-crisis-end-game-putin-gets-keep-crimea/>

March 4, 2014

WASHINGTON – What is truly worrisome about the ongoing Ukrainian crisis is that Putin sets the stage and the tempo. A startled and frankly frightened world is on edge after Putin invaded the Crimea because he got mad after his strategy to get the Ukraine back into Russian orbit failed. Instead of saying: *“You get out, Mr. Putin, or else”*, the West muttered: *“Oh Brother, what is he going to do next?”* Well, calm down. After a few days of ominous silence, Putin finally talked, saying mildly reassuring things. Relax, Russia is not going to invade the Ukraine. And the West is relieved. *“Thank God, he is going to be nice, after all. Oh Boy, this was a close call”*.

Putin determines the agenda

The upshot here is that, one way or the other, Putin is in command. The timid and disorganized West at best is in a reactive mode. Where is America’s leadership? Where is the European Union? Where is NATO? No united front. Oblique and generally innocuous statements in Europe. Big words with no chance of an organized follow on in Washington. This is the sad spectacle.

And look who is winning: Russia. A rather sorry-looking “has been”, a country masquerading as great power only thanks to the considerable cash flow provided by oil and gas exports. This otherwise semi-developed petro-state gets to determine the mood in Europe and in America. (Consider this: even with all its oil and gas revenue, Russia per capita GDP is only \$ 18,000 a year. This places it at number 77 in a descending world scale, below semi-bankrupt Argentina and just a few notches ahead of Botswana. Not exactly economic giants. In contrast, the US per capita GDP is \$ 52,000 a year. The US is number 13 in the same world ranking. And do keep in mind that the spots at the very top are occupied by special cases like Qatar, Singapore and Luxembourg).

The West has a lot more wealth

This is crazy. A semi impoverished state with a third-rate economy determines world events. It should be quite different. The West, with its power founded on real wealth creation made possible by free institutions, should dominate. And we certainly have the resources. The combined GDP of the US and the European Union is more than US \$ 35 trillion, compared with Russia's mere US \$ 2 trillion! However, instead of using intelligently our considerable wealth, we allow the neighborhood bully to determine whether we can feel at peace or under threat.

This is a bad situation. Sane people would call it intolerable.

Bringing Russia into the West

And remember that the whole point of bringing Russia into the G 7 Club (thus creating the G 8) was to make post-Soviet Russia feel welcome and at ease in the West. Ditto for its belated entry into the World Trade Organization, WTO. The idea was that a democratic Russia, willing to play by the rules, had only to gain from a closer association with the West. And what did we get as a result? The invasion of Georgia in 2008, and now the invasion of the Crimea.

An authoritarian regime

Instead of learning from the Western experience, Putin created his own semi-authoritarian state. For all practical purposes, he re-nationalized Russia's vast energy sector, while he created a climate of open intimidation against any domestic opposition. And now he proved that he is capable of truly crazy things (Crimea) when he gets mad, as in this case caused by the blistering political defeat he just suffered in the Ukraine. With no apparent fear of any consequences, Putin invaded the Crimea, and then he threatened all out war against Kiev. And he did all this, in open breach of many established international law principles, essentially with

impunity. Who is going to resist him? Nobody.

A post Cold War order?

In fact, stock markets sink when he makes threats, and they rally when he says a few conciliatory things. Therefore Putin is the modern tyrant who holds sway and whose mood changes we all must fear. In fact, as he is moody, all the more reasons to be extra nice to him, in order to avoid provoking another temper tantrum.

Is this our idea of the post Cold War international political order? Is this the end result of the carefully crafted “reset” with Russia smartly engineered during Obama’s first term, (and executed, I might add, by then Secretary of State Hillary Clinton)?

Putin will keep the Crimea

That said, even though we may have a welcome de-escalation regarding the Ukraine, as I predicted, (*see link above to a related piece*), there is no sign that Putin is about to relinquish his grip on the Crimean peninsula. The region is now under total Russian control. I believe that, as soon as things calm down a bit, Russia will force a referendum whose outcome will clearly indicate that the Russians in the Crimea want a higher degree of “autonomy” in the context of a loose federation with the Ukraine. This will be *de facto* independence and *de facto* Russian control over the Crimea.

Is this the way to make constitutional changes?

In this case, the facts on the ground favor Russia. Most Crimeans are ethnic Russians. And probably they do not mind Russian domination. Therefore, my sense is that, as long as there will be no formal breaches of basic international law principles (such as an outright annexation) the world will acquiesce. That said, even though the Russians in the Crimea may indeed prefer greater autonomy, and do not mind a

closer association with Russia, this is certainly not the way to put forward a constitutional change agenda.

This way of doing things, with a clear military threat in the background, sets a bad precedent. And this is not good. Not good at all.

Ukraine Crisis End Game: Putin Gets To Keep The Crimea

By Paolo von Schirach

March 3, 2014

WASHINGTON – The official Russian description of what is happening in the Ukraine is both interesting and frightening. It shows how, even in this hyper-connected world of instant communication and real-time, eye-witness news from the field, old-fashioned manipulation and propaganda still work quite well, at least for a while.

Russian media accounts

According to Russian media, the Ukraine has been illegally taken over by violent ultra-nationalists and neo-fascists. After staging a bloody coup, they have forced President Viktor Yanukovich, the constitutionally elected leader, to flee the country. The same rabid nationalists and neo-fascists now pose a real threat against the sizable Russian and Russian speaking community within the Ukraine.

It is therefore Moscow's supreme duty to prevent violent actions against its brethren by intervening militarily in order to avoid violence (and possibly genocide?) against

fellow Russians. Hence the decision to support local forces in the take over of the Crimea, leaving open the possibility of Russian actions in Eastern Ukraine, the region where most ethnic Russians live.

The premise is untrue

All this would make some sense if the premise –Russian minority about to be crushed, Bosnia style– were even remotely true. The fact is that the Russian sizable minority in the Ukraine was not and is not under any real threat.

True enough, among those who fought against Yanukovych in Kiev and elsewhere there are Ukrainian ultra-nationalists, and these groups are now in some fashion part of the provisional government in Kiev. But to say that neo-fascist and assorted anti-Russian nationalists *are now in control* in Kiev is a complete fabrication. And yet it is on the basis of this incredible fabrication that Putin has justified Moscow's (humanitarian?) intervention.

Spontaneous anti-Kiev resistance?

The Russian media would also like you to believe that the Kiev coup and the accompanying threat to the welfare of the Russians in Eastern and Southern Ukraine triggered a popular anti-Kiev resistance movement that sees Moscow as its natural ally. Russian media show massive pro-Russia demonstrations in Eastern Ukraine and Ukrainian military commanders in the Crimea pronouncing oaths of allegiance to the newly created autonomous regional government. The truth is that the Russians transported by bus the "demonstrators" from Russia into Eastern Ukraine, while the swearing-in ceremonies in the Crimea are taking place after Russian troops, (without insignia on their uniforms), have taken over the peninsula.

What the Russian media would like you to believe is that Moscow is simply supporting a spontaneous, popular anti-Kiev movement, all the more justified by the fact that the

provisional Kiev government is illegal, as it came into power via a coup.

Why did Putin did all this?

This being the after the fact justification offered for public consumption, why on earth did Putin do all this? In a reasonable world, this military action that creates a major crisis in Europe is incomprehensible because it is totally unnecessary. Does Putin really believe that the new (weak and poor) government in Kiev is about to launch violent anti-Russian, ethnic cleansing actions? This is preposterous.

Of course there can be cases of clashes between Ukrainians and ethnic Russians. But the notion that this is already happening in a systematic fashion, on a massive scale, and that this repression is part of a major plot ordered by the new Kiev government to crush the Russian minority is ridiculous. There is nothing to support this contention.

Lost prestige

And so why did Putin get himself into this mess?

I believe that the main reason is a rather frivolous one: hurt pride. Putin has been taken by surprise by the anti-Yanukovych insurrection in Kiev. He really thought that he had brilliantly re-established Russian hegemony over the Ukraine with promises of cheap loans to Viktor Yanukovich, so that he would abandon any plans for a closer association with the European Union.

But the strategy backfired –completely. The Ukrainians correctly saw what was behind Moscow's offer of financial help, and they staged riots that morphed into a real insurrection against a pro-Moscow regime run by a gangster.

As a result, Putin lost the whole thing.

Worse yet, he has been publicly humiliated.

And for a bully this is intolerable. Therefore he had to do "something". And so he went for the easy, soft target: the Crimea; at the same time declaring the intention to take action against the entire Ukraine.

Putin counted on Western passivity

And what about international reactions? As any seasoned bully, Putin made his calculations. NATO is now essentially unarmed. The Europeans cannot even think of any military actions against Russia, let alone stage one. The US under Obama is in full retreat. America has only few troops left in Europe and no military assets close to the region.

Given all this, is America going to go to war with Russia over the Ukraine, even though the Ukraine is a much bigger deal than the pieces of Georgia Putin took back in 2008, (by the way paying no price whatsoever for that small yet flagrant aggression)? No way. And so Putin figured that he could get away with his "soft-aggression".

End game: Putin gets to keep the Crimea

I suspect that Putin's end game is to take *de facto* control over the Crimean peninsula. This will be his consolation prize. As things calm down, he will give up any claims against Eastern Ukraine in exchange for total "autonomy" of the Crimea, with an official Russian role as the guarantor of the new arrangement. The Crimea will formally remain part of the Ukraine; but the whole world will know that Russia is in control.

With this prize in hand Putin will get back at least some of his lost prestige.

The West is of course willing to agree on any face-saving solution that will bring this unpleasant crisis to a quick end. And any agreement that does not *formally* create a partition of the Ukraine is probably fine. I suspect that

this is what is going to happen.

Tough on Russia?

Of course, there is another possible scenario. A tough and united West will impose really painful sanctions against Russia, causing real and lasting economic pain, especially to the Russian oligarchs with their super expensive mansions in Mayfair, villas in Italy and Spain and all their cash parked in London. They are Putin's allies, and an easy target .

This course of action would be most desirable; but it is predicated on a degree of unity and toughness that does not exist in Europe. As for America, even assuming the will, (and this is a stretch), it is impossible to achieve anything really meaningful by acting alone against Russia. In any event, leaving aside a few hawks in the Republican Party, I do not read any popular sentiment in favor of a protracted, tough anti-Russian stand.

Putin wins

Sadly, Putin, the neighborhood bully, will get much of what he wants, even though his actions are motivated only by the desire to shore up his battered prestige at home. US Secretary of State John Kerry correctly stated that Putin's actions and preposterous justifications belong to old-fashioned 19th Century politics. It is absurd –added Kerry– that he tries to get away with this. I agree.

Well, it is indeed strange that the head of state of a supposedly modern country would be willing to burn relationships and ties with his international partners simply because his pride has been hurt. But it is so. Putin lives in his own, rather primitive, world.

That said, it should be up to the more civilized, law-abiding states to punish his behavior and reaffirm the rules of good

conduct.

But if the civilized, law-abiding countries do not have the stomach to fight the bully, the bully wins.

Americans Waste One-Third Of All The Money Spent On Health Care

By Paolo von Schirach

March 2, 2014

WASHINGTON – The Obamacare fiasco, or at least semi-fiasco, continues to generate media attention. From a political standpoint, the Republicans intend to make the mess caused by the faulty roll out of this bad legislation a major issue in the upcoming mid-term congressional elections.

Bigger issues

That said, the heated debates about what Obamacare is doing or not doing unfortunately obscures the bigger reality of the structural deficiencies of the entire US health care sector. The Obamacare critics would like you to believe that things were just about OK until President Obama and his leftwing technocrats started messing with it. Just repeal the Affordable Care Act and all will be well. Not so. Not so.

Enormous waste

The US health care system was in deep crisis before

this reform effort, and it will continue to be in a crisis, even assuming the (unlikely) repeal of Obamacare.

How bad a crisis? Read this, from a piece by Dr. Martin Makary published in TIME magazine, (*The Cost of Chasing Cancer*, March 10, 2014):

“A 2012 Institute of Medicine report concludes that Americans spend as much as one-third of their health care dollars on tests, medicine, procedures and administrative burdens that do not improve health outcomes”.

Health care waste up to 5% of US GDP

Got that? Up to one-third of all our national health care spending is wasted. Now, if you consider that health care spending is beyond 17% of GDP, the waste (about 5% of GDP) amounts to more than the entire Pentagon budget. Yes, as bad as that. But nobody wants to discuss this. May be because the problem is too big? Who knows.

Perverse incentives

But why are we in this mess? The health care crisis is largely due to perverse incentives that are not that difficult to understand. For starters, most US doctors are in private practice. And this means that they make money only if you, the patient, come and see them. And you will do so only when you are sick. And here is a key problem.

US doctors have no economic interest in encouraging healthy life style habits –beginning with good nutrition and regular exercise– in the same way as your auto mechanic has no interest in teaching you smart ways to prevent damages to your car engine. Indeed, just as your auto mechanic makes money only when your car breaks down, your doctor makes money only when you are sick. This may sound a bit simplistic, but it is so. If everybody is healthy, doctors make no money.

Insurance will pay

And there is more. Unlike your auto mechanic, your doctor knows that you (or at least most people) have medical insurance. This means that you pay only a small portion of his bill. And this creates a powerful (and truly perverse) incentive to make the bill as large as possible.

And in medicine it is hard to determine in a conclusive way “how much is enough” when it comes to testing, diagnostics, treatments and surgeries. Therefore, as there is no real standard, let’s err on the side of caution. Let’s do “more” rather than “less”. In any event, the patient does not pay, and so he or she is not going to resist more treatment. And this explains how we get to wasting so much money: hundreds of thousands if not millions of unnecessary procedures and therapies that add no value.

Administrative costs

Add to this disaster antiquated record keeping and billing systems and you see how we get to wasting one third of all the money we spend on health care. True enough, Obamacare made this mess possibly worse. But repealing it would be no solution.

As difficult as this is, it is time to modernize the entire US health care system.

Putin Loses The Ukraine, But He Gets To Keep The Crimea –

Happy Ending?

By Paolo von Schirach

March 1, 2014

WASHINGTON – Let me give you my ultra simplified assessment of what has happened and what will happen regarding the Ukraine.

How the plot unfolded

Act 1: Russian President Putin tried to lure the Ukraine away from a closer association with the EU by promising easy credits.

Act 2: Russia and pro-Russian President Viktor Yanukovych of the Ukraine are surprised by the strong popular resistance against closer ties with Russia.

Act 3: No doubt with Russian support, Yanukovych sends riot police against demonstrators in Kiev, thinking he can just crush them.

Act 4: The rioters prove to be really strong. After weeks of street battles, they topple Yanukovych.

Act 5: Yanukovych flees to Russia. Putin has a nice black eye. His clever strategy gave him a total defeat. The Ukraine is lost.

Act 6 (*Being played now*): Putin tries to restore Russia's battered image by occupying the Crimea, an autonomous peninsula situated in the very south of the Ukraine, inhabited mostly by ethnic Russians and (on the basis of a treaty) home of the Russian Black Sea Fleet.

This move amounts to a *de facto* partition of the Ukraine. No doubt Russia will refrain from any formal unilateral annexation. It will simply "support" a new arrangement

between the new government in Kiev and the Russians in the Crimea that will grant them virtual independence in the context of a vaguely defined federation agreement.

President Obama will say that, as long as the wishes of the people in the Ukraine, (and this would include of course the Russians in the Crimea), are respected, all is well.

Grand Finale

The Russians manage to save face by claiming to be the saviors of their brethren in the Crimea. Putin is still "The Man", (at least for his home audience).

Obama can say that the US helped defuse what might have become a major crisis. (In all this, he does not look that great; but it does not matter. These days Americans do not care much about foreign affairs).

The European Union gets to lead the rescue of the semi-destroyed Ukrainian economy. In other words, they are stuck with the bill.

In conclusion...

As I said, this is an over-simplified narrative. But I believe that this is exactly what is happening. Russia cannot occupy the entire Ukraine, a country the size of Texas with 44 million people. This would be too difficult, too costly and it would look really bad.

But it certainly can occupy and hold on to the Crimea, a part of the Ukraine that is historically Russian and in fact inhabited mostly by Russians. And so it did. Russia's claim that it had to intervene in order to protect Russians threatened by Ukrainian ultra-nationalists is not terribly outrageous, and so nobody, despite the protests of the new government in Kiev, is going to do much about it.

This way Putin "loses" the Ukraine; but he can still claim

“victory”, by showing that he could act swiftly to protect fellow Russians in the Crimea.

And what about America? Well, the world will once more see that America is both unwilling and unable to do much about foreign crises. *Pax Americana* is a thing of the past.

And Europe? The Europeans now realize that they have to intervene to save the semi-destroyed Ukrainian economy. And this is going to cost –a lot.

Happy ending? What do you think?