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Russia Ignoring Its Own Bubbles

By Alexei Bayer

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The news from Russia is increasingly absurd. One kangaroo court posthumously convicted lawyer Sergei Magnitsky of committing the very crime he had exposed. Another sentenced corruption fighter Alexei Navalny for embezzlement. As this went on, Russia hosted World University Games and won almost every medal. Since at last year's London Olympics it finished a distant fourth, its success in Kazan earned it nothing but ridicule. It's as though the National Hockey League staged a kids' tournament and then fielded the Stanley Cup-winning Chicago Black Hawks against them.

Meanwhile, President Vladimir Putin blissfully explored a sunken ship while the rest of the country mourned 18 bus passengers killed in Moscow in yet another horrific traffic accident. He also sent birthday greetings to South Africa's Nelson Mandela as his travesty court jailed Navalny.

But the greatest of Russia's absurdities is taking place far away: in commodity markets in New York and London, where crude oil is trading at its highest level since 2008. Russia's ruling elites are drunk on petrodollars supplied by a massive bubble in oil prices.

In 2008, Putin blamed the country's economic crisis on the U.S. Indeed, the overbought U.S. housing market and speculation in mortgage-backed securities were the catalysts for a global financial meltdown. But this view is incomplete. The U.S. housing bubble was part of a larger - asset-price pyramid in stocks and commodities, notably oil. Just as the 2008 crisis came to Russia from abroad, so did the eight-year period of prosperity that preceded it. If the U.S. hadn't been supplying the world with cheap dollars throughout the early 2000s, the world wouldn't have been able to pay for oil, and oil prices wouldn't have risen the way they did.

These inflating and bursting bubbles stemmed from one major bubble in U.S. Treasury bonds. It began in the 1980s, when Washington started running budget deficits because of President Ronald Reagan's policies of tax cuts and military buildup. Initially, funding U.S. spending was profitable, but now bondholders are losing money. Until recently, yields on U.S. government debt were well below inflation, meaning that creditors paid Uncle Sam for the privilege of lending him money.

Since 2008, the bond-market bubble has been sustained by central banks, who are printing trillions of dollars worth of money and using it to buy government bonds. It is little different from the infamous MMM pyramid scheme that swindled millions of Russians in the 1990s. If the Russian government, instead of shutting down MMM in 1994, had bought its shares, the pyramid scheme could have still been running. It would be worth trillions, and the government would be constrained to keep funding it lest its collapse brought down the economy.

This is the situation in the U.S. Treasuries market. In June, bond prices plunged on fears that the Federal Reserve would stop buying government debt. Federal Reserve Chairman Ben Bernanke then had no choice but to reassure investors that bond buying by the central bank would continue. Since then, stocks and oil hit fresh peaks, the way they did in 2007 and 2008.

Laws of mathematics suggest that no financial pyramid can run forever, even with the support of governments or central banks. Many Wall Street professionals are starting to prepare for the bursting of the huge Treasury bubble. But in Russia, which took a huge blow from the 2007-08 global financial crisis, no thought has been given to such an outcome and its implications for the oil-dependent economy.

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