Special Report: EU = USSR Redux?

INTRODUCTION

In this special report, we analyze the collapse of the Soviet Union, and discern ten core causes of the crash of the USSR. We make a *point by point comparison with Europe today*, and come to the conclusion that its situation does not differ all that much with that of the imploding USSR. As a matter of fact, the parallells are often startling.

There are plenty of disquieting evolutions going on in Europe today: the riots in the PIIGS countries, the appearingly permanent crisis in the banking world,... Maintaining the status quo is no longer possible, that much is clear.

But what will the change look like? Will it be a steady reform, or on the contrary a sudden crash of the European Union and the euro?

Someone who is convinced the latter will happen, is the famous Russian dissident Vladimir Bukowsky. In a 2006 speech (one year before the financial crisis hit), Bukowsky made the following comment:

"*It looks like we are heading towards some kind of collapse, some kind of crisis. The most likely outcome is that there will be an economic collapse in Europe, which in due time is bound to happen with this growth of expenses and taxes. The inability to create a competitive environment, the overregulation of the economy, the bureaucratisation, it is going to lead to economic collapse. ... There will be a collapse of the European Union pretty much like the Soviet Union collapsed.*"

Mark Twain reportedly said that history doesn't repeat itself, but it does rhyme. In this special report, we search for the fundamental causes that led to the collapse of the Soviet Union, and detect whether similar trends can be discerned in Europe. After reading this comparison, the reader will be able to draw his own conclusions as to how similar the EU today really is to the failing USSR.

Here is a summary of what follows:

1. Why did the Soviet Union collapse?
   A brief overview of the last years of the USSR

2. The Pattern of a Collapse
   Point by point comparison with the EU today

3. Conclusion
   10 contributing factors compared

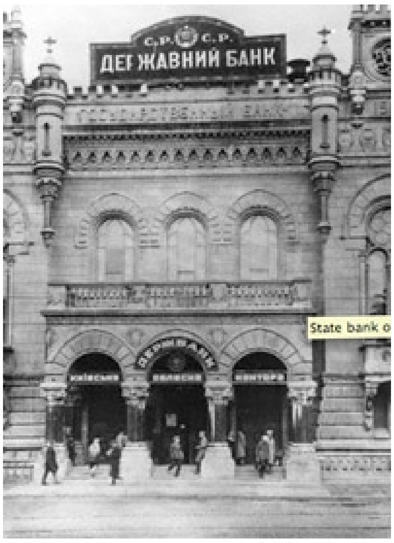
1. WHY DID THE SOVIET UNION COLLAPSE?

A centrally planned economy

From its birth in 1922, and later even more, the USSR was a centrally planned economy; the large firms were held to production quotas by the authorities (the famous 'five year plans'). A number of basic services, such as education, health care, and the transportation company Aeroflot, also were entirely government funded.

The consequence of the absence of profits and the complicated, obedience-driven bureaucratic system, caused Soviet citizens to find themselves in a permanent state of economic crisis, in a society rife with shortages, unemployment, poverty and famine. Nonetheless, the government functioned quite well, as it was funded by taxes and profits from the sale of natural resources such as gold and oil to the rest of the world.

Much of the growth of the Soviet empire was also financed with cash and credit (rubles) by the Gosbank, the central bank of the USSR, with branches that stretched all over the union. It was with the Gosbank that public companies, collective farms, and privileged individuals could acquire credit to achieve the plans of the authorities. It was also the Gosbank that provided the government with sufficient liquidity to wage a decade long war.



Gosbank: USSR's central bank

The Soviet Union's Resource Wars

As the communist system of the USSR did not allow for economic efficiency and a productive population, the government relied on the export of natural resources to fund itself: oil, coal, natural gas, steel, gold . When the production of the nations' pride, the 17 billion barrel Romashkino field, started to wane in 1976, the government started looking into new sources of revenue: expensive exploration of Siberia, and resource confiscation by means of warfare and political control.

On christmas day of 1979, the USSR invaded Afghanistan, a country that provided abundant natural resources, as well as an excellent operating base within reach of the oil-rich Arab peninsula. For the next nine years, the Soviet Union would fight a war against the CIA supported Mujahedeen of Afghanistan. Yearly cost: 2-3 billion dollars.

The Soviet Union was not only entangled in military warfare, but also in economic warfare. As James Norman documents in his book 'The Oil Card', the staggering 193 billion barrel jump in 1988 reported OPEC oil reserves was most likely a fraudulent excuse to ramp up oil production and in this way significantly lower its price, thus boycotting the USSR. The resulting oil glut indeed caused the price of crude oil to drop, even by 50%, which was a devastating blow for the already weakened Soviet economy.

As a consequence, dollar profits of Soviet oil exports plummeted, which led to a disruption of the food import chain. The huge drop in earnings, the food shortages, and the expensive measures to patch up the crippled economy (with as a sad climax the Tsjernobyl disaster, costing 13 billion dollars and employing 500.000 workers) filled the bucket to the brim: the USSR was virtually bankrupt.

The temporary solution that was thought out to postpone the problems, would lead to the ultimate collapse.

Inflation and Revolution

During the late 1980s, Moscow filled the holes in the budget with rubles printed out of thin air. And many rubels were printed in those days: in 1980 Russian banks held 156 billion rubles in deposit; by 1987, that amount had risen until 227 billion. And in that year, the liberalization of the financial sector had only begun. Whereas before, there was only one bank in the USSR (Gosbank), the financial perestroika bequeathed 1360 private banks by 1992.

At first, price inflation seemed containable, as it rose from 5,7% in 1981 to 10% in 1990. Yet the costs of living did rise faster than the wages, and citizens were faced with shortages of many kinds. This angered the population. This Pizza Hut commercial from 1986 illustrates how Russians thought about their country. Still, the government flatly denied there was a fundamental problem with inflation.

Viktor Gerashchenko and Vladimir Putin

In an attempt to keep the bankupt system afloat, the Soviet Union sold hundreds of tons of gold after 1989, in exchange for food and other favors of foreign nations.

Meanwhile the grumbling persisted, and more and more Russian civilians demanded independence from far away Moscow. Gorbachevs 'glasnost' (transparency, less censorship) was a first attempt to show cooperation without giving up the ideal of the Soviet Empire. However this was to no avail, and soon the first secessions were a fact, as several republics declared independence.

In the end, all reformation attempts failed: the USSR descended into chaos, and in November 1991 the Vneshekonombank informed the Soviet leaders that all available funds had been depleted. That was the end of an empire that had defined the global power equilibrium for three consequent generations.

After the Dissolution: Hyperinflation in Eastern Europe

The successor of the Soviet Union was a state that claimed jurisdiction over a smaller geographical area: Russia. This new political entity took on all foreign debts, and laid claim to the overseas Soviet properties. The Gosbank was transformed in the Bank of Russia, and central banker Viktor Geraschenko left the Gosbank to take command as chairman in the new institution.

Despite their newfound political independence, 15 new post-Soviet states continued to rely on the monetary union of the ruble / Gosbank. Each of them these states faced tough economic times, since under the new political constellation the former Soviet corporations suffered huge losses. In order to avoid bankruptcies, local governments issued bonds to loan rubles from the Russian Central Bank. This process of free-riding lead to an enormous increase in the money supply, and a likewise enormous collapse of the value of the ruble.

The consequences for the Russian population were disastrous: the prices of all goods soared. As the price level rose, the former soviet states asked for ever larger loans with the central bank. This self reinforcing spiral led to an inflation of up to 5000% per year in the period 1992-1994.

While the ruble hyperinflation lasted, one state after the other left the monetary union and instead installed its own monetary system. Eventually, in 1994, Viktor Gerashchenko was fired as chairman of the Russian central bank. His replacement managed to reign in inflation to about 10% per month.

THE PATTERN OF A COLLAPSE

The question we are trying to answer here is whether the situation in the European Union today is similar to that of the Soviet Union in the period right before her downfall and the hyperinflation. This is an important question, even though the EU may seem a given today, an institution that is there to stay. Powerful nations and large political entities often come to an end completely unexptectedly, as was the case with the USSR: almost no one predicted its collapse.

We here sum up the most important factors that have led to the collapse of the Soviet Union. We identified ten such factors:

1. Centralised Monetary System

One of the stipulations from the communist manifesto of Marx and Engels was "*the centralisation of money and credit in the hands of the state*". This demand was brought into practice by the USSR. From 1921 onwards, the Soviet Union's state bank, the Gosbank, took charge over the money supply, and regulated the functioning of the other banks in the country. Under the Soviet Union, the value of the ruble was coupled to the value of the dollar, which in turn was loosely based on the value of gold. After 1971, the USSR linked the ruble with a basked of large Western currencies. In other words, the ruble was fiat money, money covered by nothing and having only value because the authorities declared it so. The Gosbank operated with fractional reserves: the credits it extended did not come from real existing reserves, but were manufactured out of thin air.

As taught by Weimar Germany, the monopoly on the creation of money by one single institution makes it tempting for the political and financial authorities to start printing money *ad libitum*. The creation of credit (money) by the Soviet state bank, eroded the ruble and eventually caused it to collapse. This process of inflation empoverished and angered the people, making it a crucial contributing factor to the collapse of the USSR.

In Europe, the monetary system is also centralized. Since 1998, there is the European Central Bank, with powers similar to those of the Gosbank, such as regulating the money supply and controlling the interest rates.

In addition, from its inception the euro has been the ultimate fiat currency: covered by nothing, not linked to any nation state, and a value solely based on 'trust' (See Lamfalussy 1969, Padio-Schioppa 1999, and Duisenberg 2002). Moreover, the practice of fractional reserve banking has been dominant in Western Europe ever since the downfall of the bank of Amsterdam in 1780. This is why European banks are so vulnerable to a sudden collapse.

2. Planned Economy

The USSR economy was largely 'planned' by economic planning agencies. These agencies handed out subsidies to corporations and regulated them through quotas and other means.

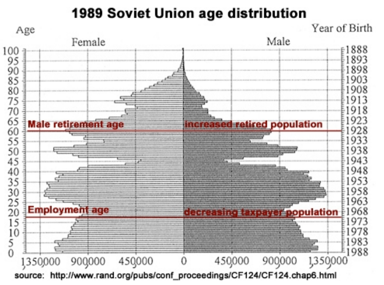
These continuous interventions caused the economy to become very rigid and bureaucratic: the markets were met with daily problems of over- and underproduction (misallocation of goods), and the general quality of the goods was low. Because of this, the Russian population was poor and the government was dependent on import of western wheat and machinery.

In Europe today, the economy is also regulated on the national and supranational level (the farm subsidies are but one example). However, so far there have been no generalized production quota, and relatively few sectors are confronted with price controls. For this reason we hold that the European Union does not fully qualify for the label 'planned economy'.

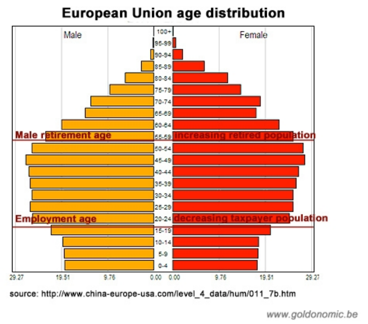
3. Centralised Basic Services

In the USSR, all citizens had a right to work, leisure, income security, and to free education and medical treatment. Fulfilling at these ambitious promises were large institutions that costed huge amounts of money to the state. With an ageing population, the costs of this vast system further increased as the eighties progressed.

Eventually, when it became clear that the government was bankrupt, all programs were stopped or drastically cut—to the horror of the Soviet citizens.



In the European Union today, the same services are also provided or guaranteed by the government: eduction is virtually entirely a public affair, medical care is almost completely financed by the government, and the pension funds are largely covered by government bonds or directly financed from tax income. Because of the ageing babyboomer generation, an ever smaller working population is providing the money for an ever growing group of pensioners.



The similarities between the organisation of basic services between the USSR and the EU are striking in more than one regard. For example, in a 1993 study from the Joint Economic Committee of the US Congress, we read:

"The pre-Gorbachev [social security] system shared many of the features that characterize social security systems in Western market-

based economies. The Soviet pension benefits were wage related, just as those in Western economies. ... Pension program financing was based on the so-called "pay-as-you-go" method, whereby current obligations to beneficiaries were funded entirely by the current generation of workers. Such programs may be funded by employer and/or employee contributions (as in France and the U.S.), government budget allocations (as in Australia and New Zealand), or a combination thereof (as in Germany, Netherlands, Sweden, and the Soviet Union Itself).”

4. High and Rising Government Debt

From 1985 to 1989, Soviet budget deficits rose from 1,8% to 9,5% of GDP. All kinds of austerity measures and bailouts (dumping of gold, issuing government bonds through the IMF, etc.) caused this number to drop to 8,5% in 1990 (source: 1, 2). However, the government expenses rose again because of the expensive food programmes, and the government income dropped because of the rising unemployment. Hence, in 1991 the budget deficit exploded to 19,5% of GDP. In the end, the debts were too large to pay with the ever depreciating ruble, and the Soviet Union collapsed.

The debt problem in Europe is not much smaller. In 2007, the official deficit of the EU member states was 0,8% of GDP. This rose to 2,3% in 2008 and to 6,8% in 2009. The PIIGS countries are worst off: in 2009 Portugal faced a deficit of 9,3%/BBP, Spain one of 11,1%/BBP, Ireland with 14,4%/BBP, and Greece was looking at a deficit of 15,4%/BBP (source: eurostat). For 2011, the European Commission predicts a further increase of the debts in every EU member state.

(sources: 1,2,3)

5. War

The CIA estimates that between 1980 and 1986, the USSR spent about 15 billion ruble (then having approx. the same value as the dollar) to fight the war in Afghanistan. 1 million Russian soldiers were involved in the conflict. This war significantly contributed to the budget deficits of the Soviet Union.

The European war in Afghanistan has mainly been a 'soft' one. Since 2002, the EU has pledged over 1,4 billion euro for project Afghanistan. From 1999 until now, the EU has had between 55.000 and 79.000 soldiers on a mission abroad.

While it is clear that the EU is involved in a military conflict, its cost pales compared to the war costs of the USSR. Thus, the two unions are different in this respect. (However, if one should consider the US and the EU as one financial bloc—and there are arguments in favor of this, given the mutual contagion risk of the banks, it was no coincidence that the FED also bailed out European banks in 2009—then the war cost of 1120 billion dollar of the Iraq and Afghanistan invasions can be brought into account.)

6. External Shock

In the way a dead tree eventually falls down because of a sudden gust, a weakened and hollow empire often falls because of a sudden external shock. As defended by James Norman in his book, the decisive economic uppercut for the Soviet Union is likely to have come from the falling oil prices of the 1980s. The 'oil glut' caused a strong fall in government revenues, which caused the Communist union to get into deep financial trouble. The oil shock was the external shock that led to the fall of the Soviet Union.

The European Union today faces several shocks. First of all a credit shock: in 2008 it became clear that the European banks are highly exposed to risky American financial products. Because of this, the crash in the US markets affected the European (financial) stocks in a severe way. This vulnerability persists, and is further nourished by the great dollar reserves the Eurozone member states hold (reportedly over $700 billion)—a crash in the dollar may affect the credibility of the euro.

In addition, as far as natural resources go, Europe, as resource consumer, is in the opposite camp the Soviet Union was: rising commodity prices in Europe make it harder for companies and governments to pay their import bills. And so this time around, it is the oil producing countries that 'shock' the old West with higher commodity prices. The unrest in Northern Africa (for example Algeria, from whom Europe buys 20% of its natural gas) and the Middle East adds further fuel to this commodity fire.

7. Transparency and Reform

In the 1980s, the Russian population got tired of the desinformation coming from the government. Newspapers published critical columns about ongoing fraud and corruption. A tipping point for this evolution was the Chernobyl explosion, a disaster the impact of which the government tried to minimise, until news came to Russia that scientists in Sweden were detecting radio-activity, coming from the east.

Politicians who favored reforms, such as Michail Gorbachev, surfed on the new popular wave, and preached a policy of *glasnost*, a word that (in contrast to what many think today) did not stand for free speech, but rather for greater transparency in the government in order to make it more efficient. In this way, glasnost became a tool for the *perestroika*, the reform movement of which Gorbachev and Jeltsin were the figure heads.

The policy of *glasnost* had unexpected consequences for the politicians: it allowed for the free circulation of information about corruption and atrocities within the government. This became a breeding ground for the independence struggle of the Soviet Republics. In this way, transparency and reformation were causes of the collapse of the USSR.

Today, a similar dynamic can be seen in Europe. One could say that the crisis of 2008 was the European version of the Chernobyl disaster: in a few weeks time, millions of people were confronted with the consequences of great and institutionalised corruption in society. The banking scandals in Iceland were paradigmatic for the troubles in the rest of the Union. There was also the crisis in Greece, whereby the fraud in the government books was laid bare (Greece lied about its deficits in order to get permission to enter the EU). The recently leaked wikileaks cables are leading to a further erosion of the confidence in the world of politics and finance. In short, *glasnost* has come to europe.

Some have already discovered that embracing the new trend can lead to political victories, such as the *piratpartiet* in Sweden, or the tea party movement in the U.S.. Shaken by the anger of the population, many EU reform programmes have been put into place, programmes that in turn will likely unveil many long kept secrets. At the same time we witness, as in the USSR of the 1980s, attempts to curb free speech in order to avoid a new systemic crisis. A striking example is the recent Dutch law proposal to ban all calls for a bank run. We can conclude that transparency and reform are two European trends of the past years and months.

8. Internal Political Unrest

In the USSR even the strongest states were weakened, and yet they had to help carry the weakest ones. Because of this, the calls for secession became ever louder, and from 1988 onwards, several republics declared independence.

The EU today faces similar problems: the less weak states such as Germany and Sweden are angry because they are forced to pay for the weakest, such as Greece and Ireland. In the corridors of the European Parliament there is talk of a 'core' northern eurozone. In countries such as Greece, Italy, and Ireland, there are violent protests against present and future bailout and austerity plans.

9. Rising Inflation

As described in part 1, the USSR faced a period of rising inflation. Europe faces similar problems.

Official inflation in the European Union is low, around three percent. However, if we look at what a European can by for his euro's on the world market today, as compared to before, it becomes clear that price inflation is a fact. For the European, in the last six months of 2010, the copper price rose by 18%, corn by 37%, and cotton by 65%.

10. Bailouts from the Central Bank

In the USSR large companies were bailed out (subsidized) on a permanent basis, by the Central Bank. Is that also the case in the European Union?

Yes. In the EU, large national and other firms are also bailed out or kept afloat by actions from the European Central Bank. Most bailouts happen indirectly, for example by allowing the ECB to buy treasuries, or by keeping the interest rate at a historically low leven, which allows companies and government agencies to get cheap loans from the private banks, or, by means of one of the many subsidy programmes for corporations.

CONCLUSION: 10 CONTRIBUTING FACTORS COMPARED

Here we show the factors analysed above in a summary table:

Conditions systemic crash	**USSR**	**EU**
Centralized monetary system	✓	✓
Planned economy	✓	
Centralized basic services	✓	✓
High and rising government debt	✓	✓
War	✓	
External shock	✓	✓
Transparency and reform	✓	✓
Internal political unrest	✓	✓
Rising inflation	✓	✓
Bailouts from the central bank	✓	✓
Conditions met:	**10/10**	**08/10**

The EU today meets eight out of the ten criteria that have pushed Soviet Russia into political desintegration and hyperinflation. Will the European Union face the same destiny as the Bear from the East?

Goldonomic is of the opinion that an inflationary depression is inevitable, and history teaches that such a monetary storm, destroying the purchasing power of millions of people in a relatively short time span, also leads to the desintegration of political structures. Such has been the lesson from the Roman Empire, from revolutionary France, and from the Soviet Union.

How exactly the desintegration of the European Union will unfold is a speculative question, but that it will come seems now inevitable. Also the Euro is in a deep crisis. Whether hyperinflation comes first, or whether the euro will be split into different new units of payment, the vale of paper money in Europe hangs by a thread. In these stormy times, a wise investor will have to look out for ways of maintaining his purchasing power by other means than fiat money and/or government bonds.

SOURCES

Albert J. Schmidt: "The Impact of Perestroika on Soviet Law"

Gary O'Callaghan: "The Structure and Operation of the World Gold Market"

Aron Katsenelinboigen: "The Soviet Union: Empire, Nation, and System"

Leon Boim: "Legal Controls in the Soviet Union"

Thayer Watkins: The Hyperinflation in Russia in the 1990's

www.cbr.ru: The State Bank of the USSR

V.A. Acharkan: "State Pensions in the USSR: Features and Trends"

Nathan K. Lewis: "Gold: the Once and Future Money"

pbs.org: "Commanding Heights"

James R. Norman: "The Oil Card"

Afghanistan online: The Role of Afghanistan in the Fall of the USSR

CIA (office of soviet analysis): "The Costs of Soviet Involvement in Afghanistan"

Rafael Reuveny: "The Afhanistan war and the breakdown of the Soviet Union"

IISS: European Military Capabilities

Wikipedia: "1977 Soviet Constitution"

Wikipedia: "Predictions of the Soviet collapse"

Karl Marx: "Manifesto of the Communist Party"

Horace White: "Money and Banking"

Anthony Jones: "The Great Market Debate in Soviet Anthology"

Patrick J. Conway: "Crisis, Stabilization, and Growth: economic adjustment in transition economies"

Joseph Gibbs: Gorbachev's glasnost: the Soviet media in the first phase of perestroika

Sergey Vassin: The Determinants and Implications of an Aging Population In Russia

Europese Commissie: Registration of Crude Oil Imports and Deliveries in the European Union