The "Russian Disease"

A look inside the dangerous, chaotic, unlawful, and unpredictable world of Russian oil.

BY MARSHALL I. GOLDMAN

With his purchase of the Chelsea Soccer team in London and along with it, the world's largest private yacht, the Russian oligarch Roman Abramovich highlighted the fact that his oil-derived wealth was now the match of anything claimed by the oil princes of Saudi Arabia. That assumes of course that unlike Mikhail Khodorkovsky and some of the other oligarchs, Abramovich is not forced to flee the country nor imprisoned.

But in prison or not, Abramovich's and Khodorkovsky's individual pranks and run-ins with President Vladimir Putin have also awakened us to the realization that as a country, Russia ranks a close second to Saudi Arabia as the world's largest producer of petroleum. And like Saudi Arabia, if those oil and gas reserves are used effectively, Russia and its leaders have at their disposal a powerful economic and political lever. Unfortunately for Russia, that lever has not always been used wisely or productively by any of Putin's predecessors, the oligarchs, or Putin himself.

Like so many other major oil-producing countries, the enormous wealth created by that oil in Russia has triggered a stormy and unsettling struggle for

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control between state officials and oil field operators. The battle has been particularly fierce—not only between the state and the private owners—but among Russian government officials. This battle has become so epic in its proportions that we can say that just as the "Dutch Disease" has become emblematic of the damage oil and gas wealth can do to the rest of a country's economy, so for countries characterized by over-abundant raw material wealth but inadequate rule of law and social mores, the "Russian Disease" symbolizes the corrupting influence that too much oil can have on a country's laws and social behavior and the no-holds-barred political and personal fight for control that the oil wealth almost always ignites. The battle that ensues is usually wasteful and divisive, on occasion even bloody and typically destructive of efforts to institute democracy and rule of law.

Oil has a long history in Russia. Not many realize that in 1905, before the Bolshevik revolution, Russia was the world's largest producer of petroleum. With the nationalization of property after the revolution, production suffered and it was not until the mid-1960s that production began to increase rapidly. Between 1970 and 1980 for example, output rose 90 percent. By 1976, the USSR had surpassed the United States to become the world's largest producer of crude oil. This in turn made it possible to export 25 percent of its output, making it the world's second largest exporter after Saudi Arabia.

Some saw this increase in output as proof of the superiority of the Soviet system of central planning. The U.S. Central Intelligence Agency, however, came to just the opposite conclusion. The emphasis on increasing output in the short run, it warned, came at the expense of extracting the maximum output over the long run.[1] As the CIA saw it, to obtain the increase in output demanded by the central planners, oil field producers injected excessive amounts of water into the wells. In the short run, this increased the pressure within the well, which made it easier to extract the oil, but after a time, the operators found they were pumping out more water than petroleum. This led the CIA analysts to predict that by 1985 the Soviet Union would cease to be an oil exporter and become an oil importer, forced to bring in 3.5–4.5 million barrels of oil per day or 175–225 million tons per year.

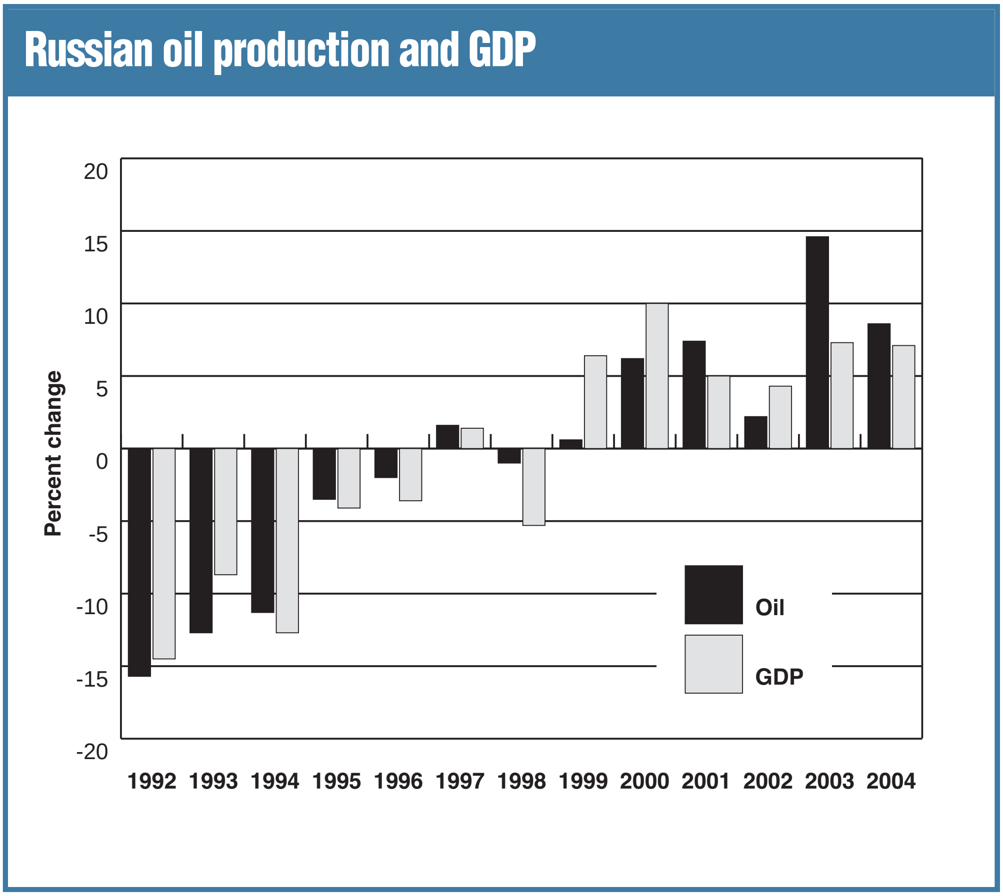
While output in the last half of the 1980s did decline slightly, the Soviet Union never came close to becoming a net importer. The CIA simply miscalculated.[2] Ironically, it may be that the reason that output did not decline more precipitously was just because of the CIA report. Soviet Ministry of Petroleum officials had been trying unsuccessfully for some time to convince the Politburo that the Soviet Union needed outside technical help from the west to prevent a sharp drop in output, but to no avail. With the publication of the CIA report, the Politburo saw there was indeed a problem and agreed to the acquisition of more suitable technologies.

Eventually in the late 1980s, output did begin to decline and by the mid 1990s it fell rapidly. But that was not for the reasons anticipated by the CIA. The main cause was the breakup of the U.S.S.R. and the piratization of industry in Russia which began in 1992.

Before the Bolshevik revolution, Russia was the world's largest producer of petroleum.

By 1996, with many newly privatized oil producers, overall output was down by about half from the 1980 peak. Instead of putting in new money for oil field investment as quickly as they could, the new owners diverted their oil export revenue to offshore tax havens scattered from Cyprus to Nauru. No one knew how long these new owners would be allowed to hold on to their newly acquired properties, so many of them decided to strip the assets and set up bank accounts for themselves outside of Russia. Besides, because of the 1997–98 financial crisis that had spread throughout much of Asia, oil prices had fallen to $10 per barrel. At that price, there was little incentive to invest in drilling new wells.

By 1999, responding to the Asian economic recovery, oil prices firmed and began to rise. Responding to the new profit opportunity, Russian oil company owners began to put increasing sums into new oil field development. Oil output rose rapidly (again disproving the CIA) and in turn so did Russian GDP.



It is instructive to keep in mind how dependent both the domestic and export sectors of the Russian economy are on energy production, especially oil. Without exception, when Russian oil production declines, GDP also drops and when oil output rises, so does the GDP (see figure). Beginning in 1999, soaring oil prices and the accompanying rise in oil output also generated a surge in tax receipts and foreign reserves. Reflecting how central oil and gas are to the buildup of these reserves, the Russians export 53 percent of their crude oil and 30 percent of their natural gas. This earns Russia $52.8 billion in crude oil and refined oil export earnings as well as $20 billion from natural gas exports. Combined, these energy exports account for over 50 percent of Russia's export earnings. This oil and gas revenue explains why Russian Central Bank gold reserves rose from a low of $12.5 billion in September 1998 to $134 billion in June 2005. In addition, with their new oil export tax revenues, the Russian government created a Stabilization Fund that by June 2005 amounted to another $32 billion. All of this made it possible in March 2005 for the government to prepay the remaining $3.3 billion of what in October 1998 had been its $19.5 billion debt to the International Monetary Fund.[3] Similarly, in July 2005, the Russian government prepaid $15 billion to its creditors in the Paris Club.[4]

Against this background, it would be surprising if control of Russia's oil producing assets did not become a major concern of the Kremlin, especially after the jump in oil prices. Moreover, it is not as if the new private owners of what until a decade ago were state-owned fields, were in any way responsible for the discovery of the oil they now are pumping. In other words, few of these new billionaires have in any way added value to their holdings by unearthing deposits that were previously unknown or inaccessible. Instead, in almost every instance, the new owners of these oil companies simply took control of already existing state companies and did it through intimidation, legal and stock manipulation, and abuse of laws that at best were imperfectly crafted.

This unearned seizure of Russia's richest assets eventually led to political pressures to redress some of the more blatant excesses of the privatization process. The first to fall victim were those like Vladimir Gusinsky, Boris Berezovsky, and Mikhail Khodorkovsky, who had the audacity to criticize or in some way stand up to President Putin. Khodorkovsky for example had the temerity to propose that he build an oil pipeline to Murmansk and another to China. It did not seem to bother him that this would mean the end of the state's monopoly over control of the country's pipelines. Nor did Khodorkovsky appreciate the fact that a pipeline terminating inside China would leave Russia vulnerable to price-cutting pressure from China. The Turks did just that when they realized that they were the only possible customer of the natural gas pipeline already built by Russia under the Black Sea.

But assuming they can avoid an undue dependency on one customer and that they can avoid mismanagement at home, the Russians are in an enviable position. Almost every country in the world is desperately seeking additional supplies of energy. In part, this is so they can back up deliveries from the Middle East in case of disruptions there or along the supply route, and in part because countries like China and India are on the way to joining the ranks of the world's largest energy importers, assuming of course that they can avail themselves of as-yet already unspoken for supplies.

So far the Russians have managed nicely to play one potential foreign customer off against another. Thus, when some Japanese offered to finance the cost of the pipeline from Russia, the Chinese responded with a competitive bid. But the Russians do not seem to be handling matters so well within Russia itself. The breakup of Yukos and the jailing of its owner Mikhail Khodorkovsky have proven to be much more costly than anything Putin could have imagined when Khodorkovsky and as many as two dozen other senior Yukos officials were either arrested or worried enough to seek refuge abroad. This had a chilling effect not only on Yukos but on some of the other oil companies as well.

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One of the more immediate consequences is that the growth in oil output has all but stopped. Whereas it was increasing monthly at double-digit rates in 2003, by 2004 oil output continued to increase but only by single-digit percentages. This year the monthly increases so far have been in the low single-digit numbers (in May output rose by only 2.1 percent) and there is a possibility that before the year is out, there may be a decline in actual output. And from what we noted earlier, any decline in oil output has an immediate impact on industrial growth. Thus industrial output in May 2005 rose by only 1.4 percent over May 2004, far below the 7 percent growth in GDP promised by Putin.

The explanation for the decline in oil output extraction is fairly straightforward. The Yukos affair has panicked not only Yukos officials but others who are already engaged in Russian oil production or who are contemplating it. One immediate effect is that almost all the oil companies have reduced their investment in the drilling of new wells. In a typical reaction, the Sibneft Oil Company slashed its investment in exploration for new wells from $57 million in 2003 to zero in 2004.[5] If the Yukos affair was not enough to intimidate them, the announcement that foreign investors such as BP with 50 percent or more equity in a Russian firm would be excluded from bidding on future natural resource projects did. Nor did it help when in 2004 the Sakhalin III offshore oil concession tender won by ExxonMobil in 1993 was revoked. It also had to be unnerving when a senior official in the Russian Industry and Energy

Ministry warned that "People who do not understand the rules (in Russia) get killed."[6] While such behavior has not held back investment from Conoco Phillips, it certainly has led to second thoughts within ExxonMobil and the French company Total, which also found its 1995 production sharing agreement unilaterally canceled by the Russians.

President Putin, in defending the return of some oil field properties to the state (i.e., renationalization), notes fairly enough that in most of the world's oil producing countries (including Norway) the state, not a private entity, is the owner. What is unsettling is that the rules in Russia change in the middle of the game. There is no rule of law, rather there is a rule of laws. More than that, recognizing belatedly how much wealth comes with the control of these oil companies, a platoon of former KGB comrades of Putin has emerged to try to seize control of these companies and take them away from the original private oligarchs. The Russians refer to these officials as *siloviki* (law-and-order types). Thus it was a state-owned company, Rosneft (whose chairman Igor Sechin was a former KGB agent), that moved in to seize Yukos' most valuable oil producing fields. It then disregarded Putin's announcement that it would be merged into Gazprom, the state-owned gas monopoly. Instead Rosneft declared it would remain an independent entity, keeping this new wealth under its—not Gazprom's—control. What makes this all the more unusual is not only that Sechin seemed to ignore Putin but that Sechin has a day job, Deputy Chief of Staff working for Putin in the Kremlin. His boss there is the Chief of Staff Dimitry Medvedev, who, as strange as it may be, is the chairman of Gazprom.

While this may be one way to replace the original oligarchs, given their rapacious behavior so far, if anything these new state oligarchs seem even less competent and law abiding. As in the Soviet era, this is likely to lead once again to the less than optimal exploitation of the country's oil resources.

Russia's energy-producing potential is so large that, damaging as it may be, none of this is likely to turn Russia into a net oil importer, at least for the next several years. But the fight for control of the country's energy wealth is all but certain to cause upheaval and waste along with uncertainty as to the reliability of Russia as a supplier and a place to do business. It should be remembered that despite assertions that Russia will adhere to its export agreements, there are still risks involved from becoming overly dependent on Russia. In the Soviet era, the Soviets suspended deliveries of petroleum to Tito in April 1948, to Israel in 1956, and to China in 1967. The practice continued after the collapse of the Soviet Union. Gas deliveries were cut off to Belarus in February 2004 which in turn affected supplies to Poland and Germany. Of course deliveries from the Middle East are hardly more dependable.

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Given the world's thirst for energy, there is little doubt that Russia will continue to be a major supplier of energy to the outside world and at least a partial alternative to supplies from the Middle East. For Russia, despite oil's corrupting influence, it is better to be a net supplier than a net consumer. If nothing else, the promise of oil exports helps to win diplomatic disputes.

Yet Russia has already discovered that there can be too much of a good thing. The challenge for Putin and his successors will be to see if they can restrain their subordinates from fighting each other and private domestic and foreign operators for control and ownership of so much wealth. Ripping up contracts, reinterpreting law, renationalizing property, replacing one set of private oligarchs with another set of state oligarchs—the "Russian Disease" inevitably leads to the destruction and squandering of assets and a loss of confidence. The record elsewhere in other oil-rich countries beset by the same challenge is not good and thus far the Russians show little sign that they will be able to do much better. ◆

NOTES

1. CIA, Program for Soviet Oil Production, ER, 77-10271, Washington, D.C., April, 1977.
2. Goldman, Marshall I., *The Enigma of Soviet Petroleum: Half Empty or Half Full* (Boston: George Allen and Univia, 1980).
3. Tass, June 10, 2005; *Moscow Times,* March 2, 2005.
4. Tass, July 5, 2005; *Financial Times,* July 6, 2005.
5. *Financial Times,* July 13, 2005, p. 16.
6. *Moscow Times,* July 15, 2004.