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How Much Would It Hurt?

EXPLORING RUSSIA'S VULNERABILITY TO A DROP IN ENERGY PRICES

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Russia's economy is obviously energy-reliant, but how vulnerable does that make it in practical terms? What would happen if global energy prices dropped significantly? In the shadow of the shale gas and oil revolution, this memo examines how a drop in energy revenues would affect Russia in three important areas: fiscal, financial, and political.

In each area, some of the effects of falling oil prices would be more or less automatic. For example, a decline in revenues would mean a rising budget deficit (keeping all other things equal). Such an effect is easy to predict: the deficit would simply be larger if the revenue loss were greater. Other implications, however, are more contingent, as they rely on choices made by individuals and groups. For instance, while observers sometimes imply or state outright that a government will be "forced" to respond to a crisis in a certain way, leaders always have some freedom to remain stubborn in the face of adversity. Likewise, there are multiple ways in which political alliances may react to stress. Those reactions are more difficult to foresee, but institutional arrangements and past patterns of behavior can guide observers' efforts.

The Nature and Performance of the Russian Economy

In order to understand how the Russian economy might react to a shock, it is important to recognize not only its weaknesses, but also the fact that it has so far avoided a number of pitfalls. The economy is not a basket case teetering on the edge of disaster; in fact, it is performing quite well on a number of economic indicators. The World Bank categorizes it as "high middle income" with a GDP per capita of almost $20,000 in terms of purchasing power parity and over $12,000 in nominal terms. Economic growth quickly returned to positive levels after the crisis in 2009-10, and the budget has generally been balanced over the past decade, again with the exception of the crisis years. Life expectancy has risen for men and women, poverty rates have been declining for a number of years, and unemployment remains low. Recent inflation has been surprisingly high, but a significant portion of that rise has been caused by domestic drought and a concomitant rise in commodity prices. Russia's external debt is far less than 50 percent of its GDP, and short-term debt is only about 12-17 percent of its total external debt. For these reasons and more, the Organization for Economic Cooperation and Development (OECD) – mainly composed of North American and European states – describes Russia as "within the range of OECD countries, not an outlier."

Certainly, Russia is dependent on oil and gas to a great degree. Fuel exports represent approximately 66 percent of total merchandise exports, up from about 61 percent in 2007. Furthermore, while the overall budget is balanced, the *non-oil* budget deficit stands at about 10 percent of GDP, which has been the case since the crisis in 2009.

Even in that regard, however, things could be much worse. Compared to petro-states of the past, Russia has been remarkably successful since the early 2000s in dealing with the impersonal, automatic effects of high hydrocarbon revenues. It has sterilized oil revenues to counter upward pressure on the ruble, and it has stored excess funds away for when revenues decline. The Stabilization Fund reached $157 billion in 2008, when it was split into a Reserve Fund ($125 billion) and a National Welfare Fund. The former was depleted to barely $25 billion during the crisis, but both funds stand at about $85 billion today. Furthermore, even during the boom years, the country has generally resisted the policy temptation to borrow against future hydrocarbon revenues for investment. Finally, to Russia's good fortune, its economy contains other significant sectors, such that total natural resource "rents" are only about 22 percent of GDP. In terms of its economic structure and policy choices, Russia is not Saudi Arabia or Kuwait (which are more economically vulnerable) or Venezuela (which is more politically reckless).

The developments in Russia that have been most troubling during the hydrocarbon boom have really been in the country's political and economic structures. Most broadly and obviously, the political system has grown more authoritarian. A bit more subtly, a variety of informal networks of political and economic actors have developed within the state that compete with each other and with formal authorities. Within this environment, a particularly detrimental form of corruption has continued and even expanded. Corruption is not always inimical to growth, as China has demonstrated for more than 30 years. However, the Russian version of corruption seems to be confiscatory, with each bribe-taker or surplus-extractor taking as much as he or she can, rather than "lubricative," where bribes are a predictable cost of business that help get things done.

Oil and gas money does not cause these problems, however, even if it facilitates them. Many other countries have had similar issues without high oil prices, including the USSR in the 1980s and Russia in the 1990s. The effects of a revenue decline on these structures and the elites who benefit from them are the most contingent and, therefore, the most difficult to predict.

Hydrocarbons and the Budget

If oil and gas revenues fall significantly, the federal budget will go into deficit. This is a simple and automatic outcome, and we have seen it happen already. Indeed, it would occur in any country that saw the price and, therefore, tax revenues of a dominant export decline. The question is what would happen next.

In the short run, Russia would cover the shortfall with the excess oil revenues it has saved over the last several years. These funds were depleted by the crisis, however so they would not last long—perhaps a year or two if oil prices did not recover.

In the medium term, Russia would probably be able to borrow effectively (that is, at affordable rates) on international markets. Its low external debt would make it attractive. In addition, its economy has the potential for growth, including from a rebound in hydrocarbon prices. Even its authoritarianism might be attractive to bond traders, who would expect that the state would use its power to extract resources from society in order to repay investors. Russia's 1997 default would be a blemish on its record, but that happened under a different regime in different circumstances. In any case, lenders are not choosing from an array of enviable options at the moment. It is possible that Russia could take a different approach, quickly cutting expenditures and refusing to borrow internationally, but taking advantage of bond markets would be the path of least resistance.

Simply borrowing to cover deficits, of course, would not be infinitely sustainable. There are some fiscal changes the government could make in order to fix a persistent budget imbalance, but these would be difficult and not at all automatic. One option would be to raise taxes on non-hydrocarbon economic activity in order to replace lost revenues. Those taxes, however, would likely suppress economic growth even further. Another approach would be to continue reducing expenditures on social welfare, perhaps by raising retirement ages, but that would cause widespread pain among the citizenry. Another area where savings could be found is in military expenditures, but that seems highly unlikely given both the lobbying power of the military-industrial complex and the version of nationalism the current administration has employed to develop domestic support. The best hope for addressing a long-term budget deficit, therefore, is economic growth in non-hydrocarbon sectors. Some growth is likely to occur because of a decline in the profitability of oil and gas (see below), but the system is still beset by destructive corruption, which will not be alleviated just because natural resource prices decline.

If no structural changes occur over several years, Russia would eventually find itself in very difficult straits. If deficits were to remain high and debt levels continued to grow, international bond markets would finally stop lending at a manageable rate. The government would find itself in a vicious cycle of offering higher and higher interest rates in order to borrow; at some point, it would have to default. That, in turn, would produce a massive currency outflow, a collapse of the ruble, a spike in inflation, and a recession. All that is possible, but, fortunately for Russia, none of it seems very likely in the next ten years unless there is an additional shock to the world economy. The stabilization fund, the ability to borrow in the medium term, the opportunities for fiscal reform, and the possibility of growth in other sectors will all work against it.

Hydrocarbons and the Ruble

If the price of oil and gas fall on international markets, so will the value of the ruble. Again, this pressure is automatic: the less oil and gas cost, the fewer dollars and euros consumers will need to exchange for rubles in order to buy Russian hydrocarbons. The way that pressure plays out, however, would depend on the speed of the decline and how the government and other actors react.

If the fall of the ruble were rapid, it would spell trouble for Russia, as it would for any other country with a currency collapse. Right away, it would mean rapid inflation, capital flight, and a near halt of foreign investment. (Ironically, the poor treatment of foreign investors by the Russian government in the past may make this loss lower than if foreign investment were currently high.) Perhaps even more important in the long run, the government would probably respond as governments typically do: with a significant hike in interest rates. This, in turn, would cause a recession, in which borrowing would slow, consumption would drop, businesses would fold, and workers would lose jobs. These effects would last far beyond any recovery of the ruble.

A slow decline in the value of the ruble, by contrast, could benefit the broader Russian economy. The automatic effects would be a decline in the attractiveness of imports and a rise in the attractiveness of Russian exports. Furthermore, there should be some pressure for diversification in the economy. Since oil and gas would be less lucrative, investment money should begin to flow elsewhere.

The good news for Russia is that a slow decline in oil and gas prices is more likely than a collapse. Furthermore, there is room for government policy to slow the decline of the ruble even if hydrocarbon prices fall quickly. Since the effect is the opposite of Dutch disease, the government could in theory relax the policies it has in place to mitigate Dutch disease. That is, it could reduce the degree to which it sterilizes revenues; indeed, this process is currently automated in the sense that the tax rate rises when the price of oil crosses a certain threshold. Certainly, oil and gas companies would lobby for a lower tax burden if the international economy turned against them.

Even then, however, the breadth and depth of any recovery would depend partly on the system of corruption that has developed in the country. If the process becomes less confiscatory, then investment in non-hydrocarbon sectors may be able to flourish. A drop in prices, however, would not in any way guarantee such a change.

Hydrocarbons and the Elite

It is important to remember that the Russian economic elite is not coterminous with the leaders of the oil and gas sectors, as it also includes figures from the military-industrial complex, the railways, the minerals industry, and banking (all of which also benefit from the success of oil and gas). At the same time, it would be foolish to understate the power of the hydrocarbon giants. Most important are the Gazprom leadership, whence came Dmitry Medvedev, and the Rosneft leadership, headed by chief *silovik* Igor Sechin, but there are many others. Gennady Timchenko, for example, an alleged associate of Putin, has made his fortune as the head of an oil trading company. Yuri Kovalchuk, also part of the inner circle, leads Bank Rossiya, which is worth billions because it administers Gazprom's pension fund, among other assets. Arkady Rotenberg, an old acquaintance of both Putin and Timchenko, owns North European Pipe Company, which supplies most of Gazprom's piping.

The political effects of a drop in oil and gas prices therefore depend in no small part on how they affect the elites connected to those sectors. The immediate and automatic impact will come from the fact that there is simply less money to go around. That will mean diminished riches for the leaders of the sector and fewer resources for paying off others in the system.

The contingent effects will depend on how those elites react. It is important to remember that their relationships are already tenuous, at best. Rosneft (Sechin) has been particularly uninterested in cooperation and appears bent on dominating both oil and gas in Russia. In oil, Rosneft grew from nothing by taking over the assets of Yukos, receiving state-sanctioned access to major oil deposits, and, most recently, purchasing the privately owned major, TNK-BP. In gas, Sechin prevented a merger with Gazprom shortly after the Yukos events, and Rosneft recently purchased Itera, once part of the Gazprom empire. Gazprom's share in Russian gas production has slipped, while Rosneft's has risen along with its oil output.

Such contentious relations among the Russian elite will not improve simply because oil and gas revenues decline. Instead, competition among the players in the system may become more aggressive and violent. Furthermore, Putin might feel compelled to turn over some of the leadership at the major hydrocarbon companies. Exactly who would fall and who would rise to replace them is unknowable, but a shake-up would be likely. There is no guarantee, however, that such a destabilization would improve the way the political economy works.

The Bottom Line

A drop in oil and gas revenue would be a significant blow for the Russian economy and its political system. Some of the effects would be virtually immediate and automatic: the budget deficit would rise; the ruble would weaken; and the elite would be shaken. The deeper impacts, however, would depend on the decisions and actions of the political and economic leadership. If they do everything wrong, both the fiscal situation and elite competition could become unmanageable. At several points along the way, however, Putin and his administration could make decisions that mitigate the damage of declining hydrocarbon revenues. If so, the system could continue to muddle along, with the economy slightly diversified and growing slowly, the system of corruption continuing with fewer resources, and the elite still fighting amongst themselves. The long-run outcome would depend less on oil and gas money than on the political acumen and authority of Putin and his successors.