

Medvedev's Oil

The Burdens of Great Wealth and the Potential for Coping with Them

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Observers have long recognized that Russia's oil wealth handed Vladimir Putin's regime numerous political and economic advantages, along with a range of potential troubles. President Dmitry Medvedev inherits the same natural endowment with similar opportunities and dangers. Medvedev, however, operates in a different context than Putin in terms of economic environment, international politics, and his own sources of authority. This memo explores the petroleum-related difficulties he is likely to face and the ways in which he might best respond to them.

In terms of the economy and economic policy, Medvedev's challenges will be similar to Putin's: coping with either the "Dutch disease" problems of high oil revenues or the mono-export problems of declining oil revenues. Putin handled the former relatively well, and Medvedev's logical course of action would be to continue his predecessor's policies. The issues associated with the latter never fully manifested themselves under Putin, but here, too, the dangers to Russia under its new president do not appear insurmountable.

It is with regard to the politics of oil that Medvedev's potential troubles seem most severe. In the international arena, major players such as Kazakhstan and China are in stronger positions than they were early in Putin's tenure, and they show every sign of continuing to strengthen. Domestically, Medvedev appears to lack his own political base, whether within the population or among political and economic elites. He may or may not be able to improve his position over time. This weakness opens the possibility of significant struggle among elites, especially if Putin proves unable to manage them

from the prime minister's chair.

Economic Problems and Solutions

As an economy that relies heavily on revenues from oil exports, Medvedev's Russia is subject to the traditional dangers of "Dutch disease," which can lead to unbalanced growth. On the world market, demand for oil exports drives up the value of the ruble, impeding other exports. At home, the success of the raw materials sector soaks up investment that might otherwise fuel other parts of the economy.

To date, however, Medvedev has continued the policies of the Putin era – policies that conform to best practices learned from the Dutch experience and which have so far limited the worst effects of the disease in Russia. Sterilization of oil revenues (through high export and extraction taxes that are diverted to a stabilization fund held in Western government bonds) helps mitigate upward pressure on the ruble. The fiscal situation is also strong, as oil revenues help keep the budget in surplus. These conditions are subject to change, of course, and inflation pressures continue, but Medvedev has a good blueprint from other countries and from the previous administration for dealing with these problems.

In addition to policy responses, the administration in Russia benefits from the fact that the Russian economy is different from those of most oil exporters. That is, Russia possesses the basic production structures to benefit from trickle-down effects from the oil sector. Inputs for the sector (like pipeline or drilling materials) can come from Russian firms rather than from abroad. Likewise, when wages rise in the oil sector, some of the increased consumer demand can be satisfied by Russian production. Assisted by state policy, Russian producers do not have to be world-class for these "linkages" to develop. They simply have to exist as alternatives to imports (and state policy can make them even more attractive). The fact that Russia's economic growth since 1999 has not been confined to the oil sector suggests that at least some of this is indeed occurring. Medvedev does not need any radical changes in policy to continue the process.

In the nearer term, as several observers have pointed out, a decline in world oil prices or (as seems more likely) in domestic oil production would threaten current Russian prosperity. Growth in the sector has slowed since 2004, and many analysts suspect there has not been enough exploration to make up for the inevitable decline at existing fields in the coming years. In addition, the poor treatment of foreign partners, a policy that has continued under Medvedev, will probably make improvements in production even more difficult to achieve, as it will hinder Russian access to the technology necessary to explore the most promising regions of the country.

Nevertheless, prospects in these areas are also not as dark as they sometimes seem. In the short run, the stabilization fund should cover budget deficits and soften the recessionary effects of a decline in oil prices. Furthermore, to the extent that foreign equipment and/or technology are essential, they can likely be obtained for a price,

despite the frustration of foreign companies at the treatment they have received so far. More importantly for the long run, a decline in oil revenues should allow the opposite of Dutch disease to set in. The ruble should slide, making non-oil exports more competitive again, and investment and other economic activity should shift to different sectors. Indeed, a slow decline in oil revenues is exactly what the Russian government should want. The challenge on the policy front will be to avoid the temptation to pour large sums of money into sustaining or expanding production. That has been the self-defeating strategy of too many “petro-states,” and it simply exacerbates the problems of relying heavily on oil.

Political Challenges on the World Stage

Regarding foreign policy, Russia has sought since the rise of Putin to use its natural resource wealth and transportation infrastructure as leverage over its neighbors. In order to do so, it needs to prevent the rise of alternatives to its hydrocarbons and pipelines. Over the next few years, Medvedev will face challenges in both these areas.

As a supplier of oil, Russia has found it difficult to use its resource as a source of “hard” power (for example, by threatening to cut off supply unless a certain policy demand is met). Such a cutoff could hurt Russia as much as those on the other side of the negotiating table. Even more problematic for Russia in the longer run, its oil customers may develop ties with multiple suppliers. This is clearly the Chinese strategy, and it will blunt Russia’s ability to use oil as part of foreign policy negotiations. Being a petroleum exporter may still afford Russia more nebulous “soft” power, providing it with a generally better negotiating environment, similar to the position in which Saudi Arabia or even Venezuela finds itself with respect to the United States. However, using that oil to achieve specific goals is difficult, and Russia’s neighbors will try to make it even more difficult over time.

Russia’s status as a monopoly transit country is potentially stronger than its position as one of many exporters in the world. Denying, or limiting, access to its pipeline system is something Russia can do with less self-inflicted injury than refusing to export oil to a paying customer. In addition, finding alternative export routes is far more difficult and expensive for Russia’s neighbors than finding alternative suppliers.

Nevertheless, Azerbaijan and Kazakhstan have done exactly this and are likely to continue to pursue such opportunities. The Baku-Tbilisi-Ceyhan pipeline takes oil from Azerbaijan to Turkey, and Kazakhstan has a direct pipeline to China. Westbound oil from Kazakhstan must still transit Russia, but the Kazakhstani government will continue to seek other options.

Medvedev’s government cannot welcome such alternatives, and it may pursue a number of potentially complementary policies, although none are guaranteed success. First, it can try to obstruct efforts to build new pipelines, although in practice this is unlikely to succeed, since the projects are, by definition, outside Russia’s jurisdiction. Second, it can foster closer diplomatic relations with its hydrocarbon-exporting

neighbors, as Medvedev tried to do during his tour of Azerbaijan, Turkmenistan, and Kazakhstan in early July. Creating a positive and trusting environment will be important for Russia if it wants to slow others' exit from its orbit, but again it will be difficult.

A more direct approach is to offer more attractive transit rates than in the past. Building a new pipeline is extraordinarily expensive, so if Russia can offer a cheap and reliable alternative, it may dissuade others from undertaking such projects. Finally, by using state-owned or state-aligned companies, Moscow can take over production assets in neighboring countries and continue to ship petroleum through Russia. During the late Putin era, Lukoil seemed to play this role in Kazakhstan, and international expansion is still a priority for the largest Russian oil companies.

In the end, however, oil exporters like Azerbaijan and Kazakhstan will always want more outlets as a source of freedom, while consumers like China will want more suppliers as a source of security. Medvedev will either have to play a very complex multilevel game quite skillfully in order to prevent such changes or learn to operate in an environment in which his sources of direct influence are reduced in number and power. He has not made any radical missteps so far, but his is not an enviable position.

Political challenges at home

The most immediate political problems Medvedev faces, however, are within Russia itself. Virtually all observers agree that he does not have his own base of power; indeed, this may have been the reason Putin chose him. Furthermore, there are two oil-related areas that seem especially ripe for damaging conflict. The first is the stabilization fund and related tools for sterilizing oil revenues. Pressures to spend from the fund or lower export taxes were already mounting toward the end of Putin's presidency, and Medvedev may be unable to resist them. As suggested above, either of these two policies can result in Dutch disease.

Perhaps even more worrisome for the regime and for the Russian political economy in general is the potential for conflicts over property to turn as violent and destabilizing as they were in the 1990s. The takeovers of Yukos and Sibneft, as well as the ongoing struggle at TNK-BP, demonstrate that claims to oil assets are far from inviolable. Observers should not, however, fall into the trap of seeing these conflicts as ones simply between the state and the private sector; the reality is even more complicated. Intrastate battles took place in the late Soviet period, the Yeltsin era, and even under Putin, and they may become exacerbated with the apparently weak Medvedev in the president's office. It is already clear that there are splits between the *siloviki* of the power ministries and others (in the oil sector, this is clearest in the disputes between Rosneft and Gazprom) as well as within the *siloviki* clan itself.

Other possibilities include fissures between the government and two large state-aligned oil companies, Surgutneftegaz and Lukoil. Those companies generally adhered to Putin's wishes but may be less cowed by Medvedev. Elsewhere in the system, oil

producers, regardless of ownership, have long-standing differences with the pipeline monopolies, Transneft and Transnefteprodukt. Balancing those interests will be a significant challenge for the Medvedev administration. Finally, leaders of oil-rich provinces (like Tatarstan, Bashkortostan, and Tyumen oblast and its oil regions) may press for greater control over petroleum revenues in their relations with the federal government. Putin kept a lid on such conflicts. Medvedev is likely to continue such strategies as consolidating regions, but his lack of personal authority may make it more difficult to manage center-regional relations.

Medvedev does have two bits of good news in this environment, although they may work at cross purposes. First, in the short run, it may help Medvedev that Putin has *not* left the political scene. Lacking his own moral, political, or personal authority over elites who have gained power since 2000, Medvedev may be able to rely on Putin to prevent a breakdown of the system and a descent into the free-for-all of the 1990s. Second, a new Russian leader without his own fully developed political network is hardly a new phenomenon; less than a decade ago Yeltsin's approval seemed to be Putin's main source of authority. If the new Russian president can avoid a systemic crisis for a year or so, there is no reason to doubt his ability to develop his own hierarchy with his own people in it.

In the meantime, what can Medvedev do to avoid destructive competition among elites in the oil sector? One near-term resource at his disposal is his ability to appoint board members at companies in which the state owns shares. If managed correctly, this tool could help him limit conflicts among and within those enterprises. This may help explain Medvedev's recent call to reduce (i.e., purge) the number of direct state representatives on boards of directors. Even if successful, however, this approach will do little to address issues at enterprises not directly influenced by the state. The fundamental problem Medvedev faces is that most of the systemic features that have made struggles over property an ongoing issue in Russia for the past two decades still exist: there are still more competitors, assets, motives, and methods of acquisition in play than there are in stable capitalist settings. The "solution" employed by his predecessors, and by leaders of other countries, has been complex personalistic politics that keep competitors balanced against each other. The next year or so will reveal whether Medvedev has the resources to pursue this decidedly suboptimal strategy, will be forced into a more institutionalized solution, or will lose control over the situation entirely.

Conclusion

Russia is a world leader in oil production and export. As such, and especially in an environment of high world petroleum prices, it cannot help but rely heavily on its oil revenues. Likewise, petroleum will continue to shape the country's politics. This was true under Putin and will continue under Medvedev.

In the economic realm, the tools for combating Dutch disease are well known and, in fact, already in place for Medvedev to use. Unprecedented world prices make the

situation especially precarious, but Russia has so far steered clear of the worst dangers, performing better than many oil exporters during the booms of the 1970s. With a modicum of prudence, it can continue to do so.

In the arena of foreign policy, the Medvedev government operates in a more difficult environment. In particular, the other players in the game all have incentives and opportunities to weaken Russia's position. While a skillful blend of tactics in the coming years may help Russia maintain some leverage over both its customers and oil exporters within the Commonwealth of Independent States, the long run will see a reduction in Russian dominance.

At home, the biggest challenge for Medvedev will be to manage the potential conflicts over the country's oil riches. Pressures to spend the revenues and, especially, efforts to carve up productive assets yet again could end any hope of broadening and deepening prosperity for the country. Although he may find a way to manage, Medvedev seems especially ill-equipped to deal with this portion of the oil legacy he has inherited.

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