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For Russia, Oil Collapse Has Soviet Echoes

Dependence on oil and gas revenue has undermined Russia's long-term economic fortunes

By Greg Ip

For most countries, the economic slowdown in China and the accompanying slump in commodity prices represent something between nuisance and pothole. For Russia, they are a catastrophe.

Russiaës currency and economy, already squeezed by Western sanctions, have been sent into virtual free fall by slumping oil prices. The International Monetary Fund predicted in July that Russiaës economy would shrink 3.4% this year, the most of any major emerging market.

That now looks optimistic. Anders Aslund, a Russia expert at the Atlantic Council in Washington, thinks 6% is more likely. Coincidentally, thatës close to what the Russian central bank predicted would happen if oil fell to $40 a barrel, roughly its current level.

As low commodity prices have impacted markets around the world, Russia may have been hurt the most. WSJ chief economics columnist Greg Ip explains why. Photo:AP

Russian growth had averaged 7% from 1999 to 2008, due in great part to high oil and natural-gas prices. The oil collapse has exposed deep cracks in Russiaës economic foundations: falling productivity, a shrinking labor force, uncompetitive industries, and private enterprise hemmed in by a kleptocratic state and crony capitalism.

The IMF now puts Russiaës long-term potential growth at 1.5%. Mr. Aslund thinks itës just 1%, astonishing for a country whose standard of living is barely 40% that of the U.S.

This matters almost as much for the world as it does for Russia. Oil and gas wealth enabled Russian President Vladimir Putin to cement his hold on power domestically and flex Russiaës muscles internationally. The loss of that wealth threatens to scramble the worldës geopolitical order, though there are no signs of that yet.

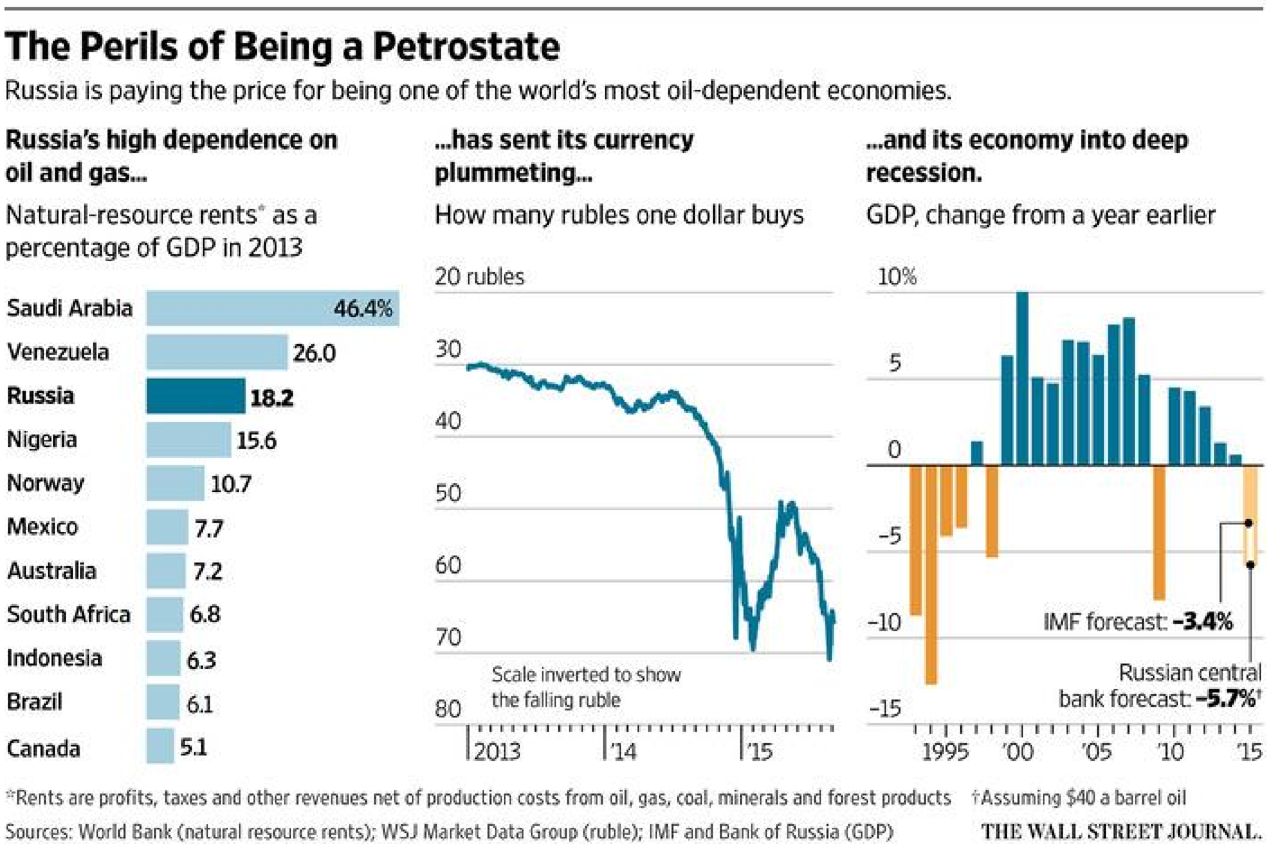
There are parallels to the events that toppled the Soviet Union. Until the 1970s, oil and gas didnět dominate the Soviet economy. It was ñan advanced (if inefficient) industrial and technological power,ò writes Thane Gustafson in his 2012 book, ñWheel of Fortune: the Battle for Oil and Power in Russia.ò

But its days were numbered. Socialist industrialization, stagnant agriculture unable to feed a growing urban population, a parasitic defense complex and uncompetitive manufacturing ñmade the fall of the regime inevitable,ò Yegor Gaidar, an architect of Russiaës transition to a market economy under Boris Yeltsin, wrote in his 2006 analysis, ñCollapse of an Empire: Lessons for Modern Russia.ò

The oil-price spikes of the 1970s staved off collapse while turning the Soviet Union into a petrostate. Oil and gas exports enabled Russia to pay for grain imports from the West, prop up its Eastern European satellites, and invade Afghanistan.

Mr. Gaidar, who died in 2009, traced the beginning of the end of the Soviet Union to Saudi Arabiaôs decision in 1985 to cease supporting the price of oil and ramp up production. The ensuing price collapse eviscerated Soviet export revenues. Forced to borrow from the West to pay for grain imports, Russia largely lost its strategic leverage, first over Eastern Europe and then over its Soviet republics. With hyperinflation and famine looming in 1991, the Soviet Union broke up.

The parallels shouldnôt be overdrawn. Unlike the Soviet Union then, Russia today is a market economy, albeit one with a large state presence. Macroeconomic policy is relatively responsible. Last year the central bank abandoned the rubleôs peg. The resulting drop has sent up inflation and squeezed living standards, but also cut imports.



Western sanctions over Russiaôs annexation of Crimea and support for separatists in eastern Ukraine have curtailed new foreign borrowing. This has preserved the surplus on Russiaôs current accountð the balance on all trade and investment incomeð and its foreign currency reserves, preventing the sort of crisis that hit the Soviet Union in 1991 and Russia in 1998.

The more important parallel is the damaging legacy of oil and gas wealth. Russia has suffered a classic case of the ñnatural resource curse,ò the tendency of easy resource wealth to prop up inefficient industry, squeeze out manufacturing, and fuel corruption. Natural resource rentsð revenues from oil, gas, coal, minerals and forest products minus their production costsð represent 18% of Russiaôs GDP, the highest among major emerging markets and far more than rich-country oil exporters like Canada and Norway. Mr. Putin has used those rents to modernize the military, expand the welfare state, and finance high-profile projects such as the Sochi Olympics.

Meanwhile, an expanding state-owned sector has undermined what private enterprise Russia had. Mr. Aslund cites the purchase by state-controlled oil company Rosneft of the well-managed, private competitor TNK-BP for $55 billion in 2013. Today, ñvalue-destroyingò Rosneft is worth less than TNK-BP was then. Western sanctions will further undermine productivity by depriving Russian industry, including oil and gas, of essential know how. As Western Europe seeks more reliable sources of natural gas, Russian exports will be further squeezed.

Former president and current Prime Minister Dmitry Medvedev had sought to spur innovation to diversify away from oil and gas. But as Russia experts Clifford Gaddy and Barry Ickes write in a forthcoming book, even those diversification efforts depend on subsidies generated by oil and gas.

Many of Russiaôs top officials are well aware of its challenges. Central bank governor Elvira Nabiullina has called the current economic slump ñstructural,ò blaming ñunfavorable demographic trendsò and the ñinvestment climate.ò

It isnôt obvious, though, that Mr. Putin and his inner circle are listening. After all, economic hardship has yet to undermine his popularity at home or his ambitions abroad. History suggests that shouldnôt be taken for granted.