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«Russia is back» is one of the geopolitical headlines of the early 21st century. What does Russia's resurgence mean for its international neighbors, partners, and energy customers – and what does it mean for the big country itself? A analysis of the situation.

(4) Russia and the Myth of an Energy Superpower

Mark Medish

There is no question that Russia's return to the world stage has been made possible by its vast mineral resources in an era of high energy prices. The Russia we see in 2007, when the price of a barrel of oil remains steadily at over \$60, looks and sounds very different from the Russia we saw and heard in 1997 when the price hovered around \$12. The transformation that has taken place in ten short years is remarkable. The financial collapse of 1998 is a distant memory. For the first time since the breakup of the USSR in 1991, Moscow is speaking with the confident – perhaps too confident – voice of a major political and economic player. Russia is clearly proud of being a member not only of the Group of Eight but also of the «BRIC» club of emerging markets – as defined by Goldman Sachs.

For seven years, Russia has achieved consistently high real GDP growth – on average over 6.5 percent since 1999. The size of the economy in 2006 reached \$1'000 billion and finally climbed over the 1991 USSR level in real terms. As President Vladimir Putin proudly notes in his final annual address to the parliament in April 2007, Russia is now one of the world's ten largest economies. The country's macroeconomic accounts are strong and well managed, with large fiscal surpluses and a prudent monetary policy.

The booming energy and mineral industries account for approximately half of the federal budget and two-fifths of GDP. Thanks primarily to hydrocarbon export revenues, an enormous international wealth transfer has occurred. The new wealth has enabled Russia to pay off most of its external official debt and to build central bank reserves exceeding \$350 billion, plus a Norwegian-style stabilization fund of over \$100 billion based on excess oil revenues. The pace of foreign direct investment has increased, although Russia still lags substantially behind other BRICs, especially China. Nevertheless, Russian energy companies such as Gazprom, Rosneft, and Lukoil are in the league of the global supermajors.

The picture at the ground level is decidedly mixed. Living standards have clearly improved, particularly in Moscow, St Petersburg and other urban centers. There is an emerging middle class; at the same time, income inequality has worsened sharply. The healthcare system is weak, and the population is shrinking. The national transportation infrastructure needs a major upgrade. The burden of state intervention in the economy, administrative red tape, a weak legal system, and rampant corruption centered around rentier capitalists and bureaucrats has slowed Russia's development of an entrepreneurial culture. Development of small and medium business – which should be an independent engine of growth – is retarded compared with other emerging markets and advanced economies.

Add to this picture a political system that lacks transparency and accountability, with hollowed-out institutions and subservient national media. Add to it also a president who enjoys enormous popularity and whose succession in 2008 generates anxiety among the vested interests at the top of society and the state – and one begins to see the complexity of today's Russia.

To understand the dynamics, three common myths about Russia and its relationship to energy should be closely examined and dispelled. The first is that Russia is an «energy superpower». The Kremlin has done much to promote this idea. Indeed, President Putin's speech in February 2007 at the Verkunde Conference in Munich exuded the confidence, if not arrogance, of an energy superpower. It is true that Russia has the largest proven natural gas reserves in the world. It is among the top ten countries in proven oil reserves and has almost matched Saudi Arabia in crude oil production at 9 million barrels per day.

But, despite Russia's vast mineral resources, there are several problems with the notion of an energy superpower. To begin with, Russia has not invested enough in the oil and gas sectors to expand current production levels. Russia may be approaching «peak oil». Without substantially higher levels of foreign investment, Russia will undershoot its energy production potential. However, foreign investors, such as Shell on Sakhalin, have been treated with a heavy hand. Furthermore, Russia itself is also the world's third largest energy consumer, and a highly inefficient one at that. Consequently, Russia's self-satisfaction at being a gas station to the EU and its ambition to supply China and Japan could soon be overtaken by its own wasteful appetite for fossil fuels.

There is no question that Russia's energy wealth has become a defining factor of its national identity, if not its national interests. Russia sees the world through oil-colored glasses. Nevertheless, criticism of Russian reluctance to ratify the EU Energy Charter is somewhat misplaced. The EU Energy Charter is presumably good for the EU and was written by countries that are mostly net importers. Yet the world naturally takes on a different look if seen by a net importer of energy or by a net exporter, just as agricultural economies and industrialized economies, or intellectual property or services-driven economies and mass manufacturing economies, do not always see eye to eye. It may not be an optimal state of affairs but it is hardly a big surprise that a major energy exporter such as Russia would be less enthusiastic about the «reciprocity» principle envisioned in the Charter.

For the ears of some Russians, superpower is a big word loaded with nostalgia for the Soviet heyday. Yet today Russia is something of a two-dimensional great power at best, based on its ageing arsenal of fissile materials and its finite reserves of fossil fuels, but it lacks a positive idea or an inspiring vision for itself and the world. There is one important sense, however, in which being an energy superpower is akin to being a nuclear weapons superpower: while you can enjoy a certain amount of prestige, you cannot really put the power to any good use externally.

This brings us to the second myth, that Russia is «blackmailing» its neighbors with its energy resources. There is an undeniable element of truth in this theory, but also a fair amount of fuzzy analysis, if not paranoia. Gazprom's disruptions of gas supplies to Ukraine and Georgia, and

Transneft's oil cut-offs to Belarus and Lithuania in the past year can be held up as prime examples of Russia flexing its energy muscle. The bullying tactics almost certainly had Kremlin fingerprints and were meant to send political messages to the neighbors. However, these moves have backfired – in the case of Ukraine and Belarus, both transit countries, by raising doubts in the rest of Europe about Russia's reliability as a supplier and spurring calls for supply diversification, and in the case of Georgia by encouraging closer cooperation with other neighbors such as Azerbaijan and Kazakhstan.

The disruptions reminded Europeans and Russians alike that markets imply mutuality: suppliers and consumers are in a co-dependency relationship. In this regard, there is an interesting parallel between the Europe-Russia energy relationship and the US-China trade relationship. Both relationships have strategic dimensions and both represent economic forms of what might be called «mutually assured destruction». To mitigate this situation, Europeans are rational to look for source diversification options, just as Russia is

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rational to look for buyer diversification options such as China and Japan, but these are long-term processes.

There is clearly a high degree of discrimination in Russian natural gas pricing. For example, the price of 1000 cubic meters of Russian gas is \$49 domestically, \$100 in Belarus, \$130 in Ukraine, \$235 in Georgia and Azerbaijan, and \$260 in Western Europe. In addition, from 2006 to 2007, prices for Georgia, Belarus, and Azerbaijan and the Baltics at least doubled, far above other price hikes in the neighborhood.

To be sure, Russia is under no obligation to provide subsidies to other countries. Here again Russia has been using heavy-handed tactics to send signals, but its actions are constrained by broader dynamics and perhaps also by the law of unintended consequences. Russia is under international pressure to raise domestic prices toward global market levels in the context of its WTO accession. So, sooner or later, the game of energy subsidies will come to an end. Furthermore, it is probably wise for countries with lesser energy endowments such as Ukraine, Belarus and Geor-

gia, to stop consuming energy like resource-rich countries. These structural adjustments are inevitable. Russia is unintentionally doing these countries a service by stimulating deeper reforms making them less dependent on Russia in the long term.

There are also fears that Russia is using its wealth to buy up energy transit and distribution assets in the immediate neighborhood and in Eastern Europe. Russian state-owned or state-backed companies are seen as predatory. The right thing to focus on, as anywhere in the world, is the use of corrupt or manipulative practices. But here we must also be frank about Russia not being alone in thinking about «energy security» – and thus mixing foreign policy with energy – or in promoting the idea of «national champion companies». Western super-majors are as eager to gobble up foreign assets as are the Russians. There is an element of moral equivalence here.

The third and most challenging myth is that Russia suffers from an «oil curse» – from being too well endowed with hydrocarbon resources. This theory, as developed by Jeff Sachs and Tom Friedman, is that energy-rich countries are gen-

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erally doomed to be mis-developed and mis-governed. Many observers have concluded that Russia is under the oil curse and is becoming a new «petrostate», essentially a Slavic emirate with nuclear weapons.

In terms of clinical probabilities, the oil curse diagnosis has some validity. As a result of oil wealth, the temptation to avoid economic reform is enormous. It is easy to see how a soft budget constraint would lead to massive waste, energy inefficiency, and poor resource allocation; how «Dutch disease» could grow due to currency appreciation, preventing industrial diversification; how vulnerable such an economy would be to downward commodity price shifts; and how corruption could become rampant and crippling. One thinks of Nigeria and many of the Gulf States as leading examples. Russia may have some of the curse symptoms but not others.

The key point is that curse is the wrong word because the phenomenon is far from inevitable. For example, the US managed to develop well despite its vast resource wealth, including mas-

sive oil reserves. Norway is a more recent case of smart oil-driven development. Policies matter. Choices make a difference.

Indeed, natural resource wealth is not a curse, it is a big opportunity. Opportunities can be missed, but they are still opportunities. Russia may fail to take advantage of its resource wealth. If it does fail, this will be the result not of pre-determination, but of specific policy mistakes and bad decisions.

So far Russia has managed its oil and gas export windfalls in a reasonably prudent manner at the macroeconomic level. Its leaders would be wise to stay on this course but also to think much more carefully about the sub-macro levels and about improving governance and key institutions, about building a political economy that favors diversified, dynamic, and sustainable development – in short, about the future beyond oil and gas. As Russia heads into the political uncertainties of presidential succession in 2008, it is unclear that the leadership is focusing on these critical issues.

In short, Russia has a strategic choice to make: to master its own resource wealth or to be mastered by that wealth. This choice will also have important implications for Russia's role in the world.

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