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REP Roundtable Summary

The 'Resource Curse' and Russia's Economic Crisis

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10 March 2009

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Russia is the world's largest gas exporter. For a brief period it was also the world's biggest oil producer (though not exporter). In recent years Russia has sought to define itself as an 'energy superpower'. This idea has become doctrinal for the Russian leadership. There was a conviction that the oil and gas wealth would last a very long time, and hydrocarbon resources could be made the foundation of the Russian economy and international power. However, between 2006 and 2008, little investment was made in the Russian energy sector. In 2006/7 the rise in production volumes halted. In 2008, extraction volumes started to fall.

The biggest problem with the energy sector is a lack of investment. In the case of Gazprom, a large amount of its expenditure is directed towards non-core activities, such as construction, media holdings, and even the Winter Olympics complex in Sochi. Just 43 per cent of Gazprom's investment goes towards its primary business activity. In addition, Gazprom is now more interested in building pipelines than increasing extraction volumes, improving efficiency, or identifying and developing new reserves.

There has been a great deal of discussion about the need to improve energy efficiency in Russia, but little action has been taken. Two-thirds of Russian gas production is consumed domestically – equivalent to the total consumption of Japan, Italy, UK and India, which have a combined GDP 13 times greater than Russia.

In Kazakhstan and Azerbaijan, hydrocarbon extraction has increased despite the fall in prices. This is not the case in Russia. In the Communist period, the Russian Soviet Republic accounted for 94 per cent of the total gas extracted in the USSR, and 90 per cent of the oil. Today, Russia accounts for 72 per cent of the gas and 78 per cent of the oil extracted in the former Soviet Union.

The decline of Russia's energy sector may be hastened this year owing to the indebtedness of many Russian energy companies. We should expect a drop in output of between 3 and 5 per cent in 2009.

The second major challenge facing the energy sector, and Russia's economy as a whole, is spiralling costs. The resource curse in Russia is unique in the developed world. Elsewhere, when wealth increases, competition intensifies and prices are forced down. In Russia, monopolistic and anti-competitive practices prevent this. For example, there are 11 companies producing cement in Russia. In China, there are over 6000. Three companies control the retail sale of oil in Russia. In the United States, there are over 20. Lack of competition leads to a growth in costs. In 2000, one litre of petrol cost 19/20

US cents. Now the cost is \$1.15. In 2000, the average cost of one barrel of oil equivalent was \$3.80. This figure was about the same for Yukos and Rosneft. The cost of producing one barrel today stands at \$10.80. The average price of cement in Russia has increased 4.5 times. The average price of non-ferrous metals is now 3.5 times higher. Housing prices have quadrupled in five years. This is partly due to bureaucrats extorting money from developers. Obtaining all the necessary paperwork for a new development is estimated to cost \$1,600 per square metre of real estate. This is why apartments in Moscow can now cost in the region of \$5,000 per square metre.

However, the government does not appear to regard the increase in prices as a problem. The oil and gas revenues have provoked a big spike in wholesale prices, but there have been no moves to try to liberalise the economy further or improve efficiency. In fact, the reverse is the case: the Anti-Trust Committee recently allowed a merger of three big metal processing companies into Rusal, with the only proviso being that domestic metal prices should not be more than 5 per cent higher than the rates quoted on the London Metal Exchange. Why could the Committee not have stipulated that the price be 20 per cent below the stock market level?

When costs are so high, it is hard for businesses to innovate and develop. Major projects have been delayed, or delivered well over budget. The high-speed railway between Moscow and St Petersburg does not exist. There is now talk of transferring the Asia-Pacific Economic Council Meeting from Russkii Island off Vladivostok to Strel'na, St Petersburg, as it has become evident that the grandiose development plans can't be fulfilled. The Winter Olympics complex in Sochi is also at risk, even though lots of money is available for the project. There is not enough cement production capacity in Krasnodar Krai because existing factories are working flat out to support the reconstruction of South Ossetia and Abkhazia.

The fall in oil and gas prices will have a damaging effect on the budget. In 2008, there was a budgetary surplus equivalent to 4 per cent of GDP. In 2009, we can expect a deficit of 12 per cent, equivalent to \$100bn. Government revenue is falling, but expenditure is not decreasing commensurately. The Government needs to reduce expenditure, and it must do so by addressing the systemic problem of inflated prices, rather than cutting back on individual projects. At present, major public works are delivered at excessive cost. In August 2008, Moscow's mayor Yury Luzhkov agreed to build a fourth ring road in the capital. The cost per km of the road is projected to be 511 million euros. By contrast, the most expensive road works

in Europe, the 2.4 km-long Milau bridge in France, designed by Norman Foster's company, cost 411 million euros for the whole project.

The fundamental problem in Russia is a lack of competition and the dominance of monopolistic trends. One of the most profitable – and criminal – areas of the Moscow banking business is the practice of *obnalichka*, the conversion of bank holdings into cash. This involves a series of fly-by-night companies; the going rate for such (illegal) transactions is generally 8 per cent of the total sum. Sources within the banking industry say business is currently at a standstill, and the reason is that the state budget has not yet been approved. As soon as this occurs, demand will pick up, because the main customers of these banking 'services' are involved in state projects.

The biggest challenge for the government is thus to slash costs, improve efficiency, and reduce inflated prices. This is unlikely to happen, however. Everyone in government is simply waiting for hydrocarbon prices to rebound. At a recent economics forum in Krasnoyarsk, everyone, from Zhukov to Dvorkovich, discussed what would happen to the economy when oil prices recover. No one was considering what would occur if they didn't. It is unlikely that oil prices will bounce back quickly. It may take until 2011/12. This will be extremely painful for Russia. All of its reserves will be exhausted by the end of this year.

If the Russian government wishes to strengthen the economy, it would have to follow the path of countries such as Poland, the Czech Republic, Hungary, South Korea and Taiwan, which have successfully pursued a 'catch-up' model of industrial development. Some Russian economists argue that as the country is highly educated, and has a great legacy of scientific achievement, it can leap forward into post-industrial prosperity. In their view, a sizable proportion of Russian industry could become internationally competitive. This seems a dubious logic. Successful post-industrial economies, such as the UK, US and Germany, have all gone through a period of successful industrial development. There is no precedent for countries to skip over this stage. There is also a lack of talented officials within government capable of promoting industrial development. Even the opposition and intellectual elite promote a pure liberal economic model; they are not managers who see the need for the government to lead industrial development from the front.

Russia's economy will not recover until the global economy rights itself. There will be a lag of some 9-15 months. If recovery starts in Europe at the end of 2009, it will not be until well in to 2010 before growth returns to Russia.

Discussion

The Stabilisation Fund was created in part to keep prices down. Why has this not succeeded? What amount of money is now in the stabilisation fund? What is the real level of inflation?

The stabilisation fund provided some check on inflation, but it didn't completely eliminate the problem of high prices. The Stabilisation Fund was divided on 1 January 2008 into two parts, creating a Stabilisation Fund and a \$60 billion 'fund for future generations'. The Stabilisation Fund will be used to cover budgetary deficits this year. It may be exhausted by the end of 2009. Last autumn, Putin authorised the use of \$6 billion from the second fund as a loan to Vneshekonombank. \$1.7 billion of this was used to try to prop up the Russian stock market. This was unsuccessful. The government has realised that this policy will not work and that the money was essentially wasted.

The official rate of inflation is 13 per cent. It is difficult to say what the true level is. Many basic products, such as potatoes, which are a staple of many poorer people's diet, are not included in official inflation calculations. Inflation on food is higher, around 22 per cent, whereas prices for luxury goods have not increased. Thus the poor are hardest hit.

A large proportion of government revenues comes from taxes on the energy sector, which is in desperate need of investment. As the crisis bites and the budget goes into deficit, does the government squeeze the energy industry harder to try to fill the hole in the budget, or increase investment in the industry so that it can start to increase production volumes again?

The government itself does not know the answer to this question. There has been a lowering of export duties on oil. It has been reduced from \$500 per tonne to \$130. It may be lowered to \$100. This has led to big falls in government revenue. 55 per cent of government receipts come from oil exports, so cutting export tariffs creates big funding gaps. At the same time, energy companies are looking to cut production. The government has no strategy on what to do to remedy the situation. It has lowered some taxes to give the energy companies more breathing space, but it has no long-term plan. The gas situation is different. Certain export taxes don't apply to Gazprom. The tax burden on the company is four times lower than for the equivalent amount of oil exported, so it is unlikely charges will be reduced

further. The government may eliminate taxes on the development of small gas fields. At present, many smaller fields are not commercially viable.

Is there any prospect of Russia joining OPEC?

OPEC requires its members to adhere to rules governing production. Russia will not join OPEC because it does not want to be subject to these rules. The leadership doesn't want to obey any rules at all – it wants to be setting them.

Putin's popularity and legitimacy has rested on an implicit contract whereby political freedom was circumscribed in exchange for economic well-being and sustained growth. Now that the Russian economy is contracting, what does this mean for the leadership's popularity, and regime stability?

The vast majority of the population believes that the economic crisis is the result of objective problems which exist everywhere. They don't blame Medvedev and Putin for the downturn. To a limited extent they are right. Boris Nemtsov and Vladimir Milov recently published another report in which they blame Putin entirely for the crisis. It is absurd to blame every aspect of the current crisis on Putin. Many of the statistics in the report are incorrect.

The political situation in Russia is quite stable. The government must be careful not to defend narrow group interests, as happened recently when Putin introduced tariffs on imported Japanese cars in the Russian Far East. This was an utterly unnecessary measure. It was a small issue, but it provoked a wave of protest. It is impossible to defend domestic car production like this. As long as the government avoids repeating this mistake, there will be no major political trouble this year.

How well is the Medvedev-Putin diarchy working? How credible is talk of an impending split between President and Prime-Minister?

Of course there is a certain amount of tension between Putin and Medvedev. This was evident during the preparations for Medvedev's address to the Federal Assembly, when the draft speech was rejected by Prime Minister's office. Some insiders say Medvedev was furious at this. When Medvedev first came into the spotlight, he was extremely uninspiring. Since then, he's made a great deal of progress. However, he has no supporters, no powerbase.

Things may change if people realise Medvedev is starting to acquire greater power. This won't happen soon, it will take a few years. He is not a puppet; he wants to act independently.

You mentioned that a lot of resources are being directed towards the redevelopment of South Ossetia and Abkhazia. Is this sustainable? Kyrgyzstan has been promised \$2 billion by the Kremlin – will it ever receive it?

Problems are mounting in South Ossetia and Abkhazia. The government has promised 10 billion roubles. So far only 2.2 billion roubles have been dispersed. Experts say that the funds are being mismanaged and there is a great deal of fraud. Moscow insists it wants its own controls on how the money is used. The South Ossetian elite rejects this. There are thus growing tensions about how the aid should be used.

The Volga region has been badly affected by the diversion of funds to Abkhazia and South Ossetia. The governor of Krasnoyarsk Region has said that there are only enough funds remaining for one and a half months. That was two weeks ago. There are big problems in the regions. Nikita Belykh, the new governor of the Kirov Region, has said that his regional budget has been cut by 30 per cent.

I'm confident the loan will be given to Kyrgyzstan. The Russian political elite is obsessed by geopolitical problems. It is a waste of money, but the promise will be fulfilled.

How can Russia develop a post-industrial, highly developed economy? Following the South Korean model requires a high level of Foreign Direct Investment, which presupposes a very different economic and legal environment.

In Japan and South Korea the government played a crucial role in encouraging growth. Russia needs to follow this model. If it succeeds, FDI will follow. An influx of FDI alone will not transform the economy. Russia has a lot of money to invest in development, if it makes the right choices.

When issuing tenders for big public projects, the government should place the funds for the project in a western bank account, to be released only at the point of completion. This would limit bribery and prevent subcontractors inflating costs.

The political elite drew important lessons about fiscal discipline from the 1998 crash. What lessons, if any, do you think the elite will learn from the current crisis?

It is hard to say what lessons will be learnt. The elite view the crisis as a foreign import, and they believe their task is simply to weather the storm. The leadership does not want to change course, or their system of management. They believe the oil price will eventually start to climb, everything will return to normal, and there is no need for reform.

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