BOOK REVIEW

Is Russia Becoming an Unstable Petro-State?

By Peter Reddaway, Washington, D.C.

Thane Gustafson, Wheel of Fortune: The Battle for Oil and Power in Russia, Cambridge, MA: The Belknap Press of Harvard University Press, 2012.

Over the last forty years, the global cost of oil has played a central role in a series of startling economic and political developments. The rude price shocks of 1973 and 1979–1980 awoke the world to the fact that henceforth oil would no longer be viewed as a cheap fuel. While whole populations had become addicted to it, its cost would now be a lot higher—and also wildly unpredictable.

For oil-importing countries, this was bad news. At the same time, the major exporters faced a different challenge: either use the windfall profits to strengthen and diversify their economies and be ready for the times when the oil price would plunge; or neglect all this, drift into addiction to the high prices by squandering them on corruption and hand-outs, face fiscal crises when the bad times come, and be labeled a petro-state[1].

Twenty years later, the giddy rise in the oil price that began in 2000 and soon spiraled from $25 a barrel in 2004 to almost $150 in 2008 gave exporters unprecedented opportunities to choose between the two paths—financial security or petro-state. But it caused serious pain to importers and exacerbated the world economic crisis that we have yet to put behind us.

However, the high price also provoked an unexpected and positive response. In the last few years the United States has suddenly shifted from experiencing a disturbing long-term dependence on expensive imported oil to seeing an increase of about 50% in its own crude oil production and the prospect of becoming the largest oil producer in the world by 2020. This has resulted from small flexible companies using refined techniques like hydro-fracking to break up layers of rock and extract so-called "tight oil". The U.S. shift has also contributed to a sharp decrease in the world oil price since June 2014.

In 2014, Vladimir Putin's irresponsible actions in Ukraine made clear that Russia's important role in the world oil market will be declining in the next few years. As a result of this and other factors, Russia may soon become politically unstable.

With this evocation of the volatility of oil issues as background, let us turn to a key and highly topical question: does the ominous label petro-state apply to Russia? This is where Thane Gustafson's *Wheel of Fortune: The Battle for Oil and Power in Russia* provides major help. The book is a history of the politics of Russian oil since the late 1980s that wrestles with, inter alia, exactly this question. The author concludes: "The Soviet Union was not a petro-state; but post-Soviet Russia is increasingly taking on the characteristics of one."

Gustafson's book is the fruit of a decade of research that draws on the insights of scores of experts in the oil industry, governments, think tanks, and universities[2], in Russia and the West. It splices together into an elegant and original analysis the essence of hundreds of books and articles and dozens of interviews and site visits.

Many of the Reforms Needed in the Late Soviet Period Are Still Needed Today

While *Wheel of Fortune* is an organic work that's equally accessible to scholar and generalist, it is also a sequel to the author's pioneering volume of 1989, *Crisis Amid Plenty: The Politics of Soviet Energy under Brezhnev and Gorbachev.* This covered the period from the 1960s to the 1980s. It is striking that the two books reach broad conclusions that, while the contexts differ, nonetheless have much in common. In *Crisis Amid Plenty* Gustafson sees one of the principal results of Brezhnev's failure to reform energy policy as being "the Soviets' drift into nearly exclusive reliance on oil as their primary source of hard-currency income." He also notes, writing in 1989, that while "the energy sector is a fertile and comparatively easy field for middle-range reform," if Gorbachev and his colleagues "do not act decisively," they "will find that the energy sector will continue to generate crises, diverting their resources and attention from the more difficult and fundamental tasks of reform elsewhere in the economy. In that case, the most reformable sector of the system will continue to block reform elsewhere." On the critical question of whether the political will to pursue reform—through

1 A few major exporters, notably Norway and more recently, though to a lesser extent, Brazil, have avoided this label by harnessing their windfall profits, or rents, to the task of diversifying their economies, raising living standards, and building national strength. Others, like Nigeria, Iran, Iraq under Saddam, and Saudi Arabia, have had such profits purloined by their rulers and, in varying degrees, wasted—in the sort of ways indicated above. Although the USSR was not a petro-state, after the Soviet leaders in the 1970s took the second course. The sudden price collapse of 1986 contributed to the subsequent demise of Mikhail Gorbachev's government.

2 As a colleague in the field of Russian politics, he sought my views on a number of topics, views that have not always coincided fully with his own. See later in this article.

extensive economic liberalization—still existed, by late 1989 Gustafson was developing doubts.

What does *Wheel of Fortune* conclude on similar issues? Gustafson shows that by 2010 the Kremlin's receipt of massive windfall profits from oil exports was being divided among numerous claimants, including via "an explosion of corruption." As a result, "a large part of the political and economic system had become based on oil rents."[3] He then asks: "Will the oil industry in the decades ahead be able to continue supplying the rents that support the system? The answer of this book is that it will not—unless there is a determined effort to accelerate the modernization of the oil industry itself. And that effort will be successful only if it is accompanied by a renewed commitment to modernization and reform of the political and economic system as a whole." On whether the political will for such strong medicine existed when Gustafson was finishing this book in 2012, his doubts had, as we shall see in a moment, become quite profound.

Thus the Kremlin's essential predicament in the late 1980s and again today, a quarter century later, shows little change. Preservation of the political status quo depends on a continuing influx of oil rents from abroad. And only by reforming the lucrative oil sector would it be possible to fund the essential, much bigger, and daunting task of modernizing the economic system as a whole.

What actually happened after 1989 was a plunge in the oil price, a decimation of rents, and soon—total catastrophe. Gorbachev's regime collapsed, and the USSR disintegrated.

What about the prospects today? Gustafson foresees the probability of a hefty reduction in the oil rents available to the Kremlin, due in part to the exhaustion of the Soviet oil legacy and a related steep rise in the cost of extracting oil. Often in smaller quantities than before, today's oil has to be transported from locations that are increasingly remote. Thus "the oil industry requires larger and larger inputs of capital, but responds less and less to each successive injection." Another threat to oil rents is a probable long-term decline in the oil price.[4] This will likely begin, he believes, as the global demand for oil levels off—and then goes down in response to the current surge on world markets of, in particular, cheap natural gas.

3 These statistics illustrate the growth of rents and their impact on Kremlin tax revenues: whereas in 2001 oil accounted for 34% of Russian export revenues, by 2011 its share had swelled to 52%; in dollar terms, whereas in 2000 oil export revenues were $36 billion, in 2007 they had risen to $173 billion; regarding tax revenues, whereas in 2001 oil and gas together provided 20% of government revenues, by 2011 this had grown to 40% from oil and 9% from gas. (pp. 5, 360)

4 This decline took off in the months from June 2014. See the end of this review.

All this is ominous for the Kremlin, because "rent dependence … is not simply at the heart of the system; it *is* the system. The obvious implication is that if the flow of petroleum rents were ever to slacken, Russia would be deeply destabilized."

Thus if today's Kremlin regime is to survive, it would have to heed Gustafson's above-quoted advice. Its first priority would be to modernize its essential life support system, the oil industry, and thus increase revenues. Concurrently, Western-type reforms of the whole economy and polity would be required, paid for by the larger rents. However, Gustafson evinces little hope that the conservative President Putin, whose views, like Brezhnev's in his day, favor the status quo, will embark on such a path. Indeed, he sees "growing elements of similarity between the Brezhnevian *zastoi* (or stagnation) and Russia's present regime."

On the other hand, Gustafson believes that if a new leader were to emerge and prove politically capable of adopting the sound economic strategy of former finance minister Aleksei Kudrin—a remote contingency for now—the outlook would greatly improve.

The Chaotic and Corrupt Privatization of the Oil Industry in the 1990s

To turn to the author's rich historical narrative, let me note first his analysis of the scientifically solid and relatively sophisticated oil industry of the Soviets. This developed as part of a broadly based industrial economy that did not match the model of a petro-state, whose economy must be dominated by oil and/or gas. As Gustafson points out, only from the 1970s on did the Soviet leaders give the USSR a petro-state tinge. This was when they used fossil fuel exports "as a means of propping up their sagging system, while avoiding change."

However, these industries, like the state's economic system as a whole, were inefficient, isolated from global competition, and, as time went on, increasingly prone to corruption. For these reasons the socialist economy could not withstand the competition introduced first by Gorbachev's ill-conceived reforms and then by the hurricane of market forces unleashed by the Soviet Union's collapse. Thus Russia's massive dependence on fossil fuels resulted from "the implosion of the Soviet industrial system." This earthquake "left natural resources, chiefly oil and gas, as the chief remaining sources of value, while Russian manufactured goods became even less competitive in global markets than before." In short, Russia quickly assumed the appearance of a petro-state.

As regards the chaotic developments of the 1990s, Gustafson picks his way through them with a sure touch, analyzing both Kremlin policy and the bruising hurly-burly of the increasingly privatized oil industry. Meanwhile, the gas industry exits his stage on its own trajectory, in the form of the majority state-owned monopoly Gazprom, to return only briefly in 2004–2005.

While the oil industry disintegrated much less in the 1990s than did Russia's industry as a whole, the drop in its annual production was frighteningly large. Whereas in 1987 Russia led the world with 11.4 million barrels a day, in 1996 production bottomed out at 6 million, or little more than half. While production recovered and later approached that of 1987, government experts warned later that it could go down to as little as 8 million by 2020. The Soviet oil legacy had been used up and current investment was too low to finance exploration of Russia's promising Arctic off-shore sites. Moreover, "tight oil" would not be a solution unless the number of nimble independent oil companies could—in the face of Russia's daunting statist tradition—be rapidly multiplied.

Behind the production collapse of the 1990s lay alarming upheavals that Gustafson describes with vivid vignettes. In the winter of 1991–1992, for example, "every day, more of the state companies' assets leaked to the private structures that were springing up all over oil country … as the Soviet-era stake-holders, not knowing what the future held, prepared makeshift lifeboats and began lowering away." The Soviet oil and gas ministry dissolved amid the general chaos, to be replaced by a weak Russian structure headed by an even weaker minister. This hapless official had to endure unrelenting contempt from the "oil generals" who headed state and private oil companies, as they struggled to keep the industry afloat in far-flung locations. In 1992, Gustafson attended a stormy summit of the oil industry in Samara. Here "the minister and his deputies faced the wrath of the oil generals. It was a scene straight out of an Eisenstein movie": the officials "sat lined up on a dais, looking on helplessly while the angry oil generals shouted and waved their fists." One of the latter "looked ready to charge the dais." A strike that threatened to shut down oil-field production required immediate action. Yet the minister could give him no help.

In the treasury, meanwhile, the Kremlin was trying to stanch the hemorrhaging of state revenues caused in large part by the plunge in oil rents. Eventually, in 1994, it brought some order to the violent, semi-criminal world of oil exporting. This helped to appease the International Monetary Fund, which soon produced enough funding to, for a while, keep Russia afloat.

In 1995–1996, with ad hoc privatizations of pieces of the oil industry already underway, Yeltsin's aide Anatolii Chubais decided to bet on some of the young businessmen who—as deal-makers, bankers, and financiers—were aggressively participating in this ruthless process. Through the rigged auctions of the notorious "loans-for-shares" privatization of state companies that he organized, the government "transferred a large share of Russian production of oil and other commodities to the new financial empires" of these businessmen, thus "within a few years turning their multi-million fortunes into billions." In the process the Kremlin created the coalition of so-called oligarchs—Roman Abramovich, Boris Berezovsky, Mikhail Khodorkovsky, and others—that financed Yeltsin's re-election in 1996. However, for doing all this, the government paid a hefty political price. The operation discredited its program for privatizing state assets "and damaged the reputations of the remaining reformers, particularly that of Anatolii Chubais."

Gustafson's intricate but gripping account of the turbulent events of 1991–1996 corrects many previous descriptions of Russia's privatization. Above all, it shows that far from the loans-for-shares takeovers having been a breakthrough, they "were more like the last act, a final state blessing … to a process that had begun two years before."

However, as the 1990s progressed, privatization and the creation of the oligarchs did not arrest the steady weakening of the state. This stemmed from chronic budget woes, low oil rents, two years of brutal war against Chechnya, and increasingly erratic, often incompetent rule by Yeltsin. By summer 1998, when the government defaulted on $40 billion in treasuries and the ruble lost three quarters of its value, all the large oil companies had been privatized. Although two of them (LUKoil and Surgutneftegaz) were headed by cautious Soviet-era oil generals who retained some loyalty to the Kremlin, the rest belonged to financial oligarchs who knew exactly how to exploit a feeble state. Increasingly, if in varying degrees, they asserted their independence and devised ever more ingenious ways to avoid paying taxes.

Putin Restores State Control of the Industry through Taxation and the Arrest of Khodorkovsky

Some of these trends went into reverse in 2000, after Yeltsin designated Putin as his successor and promptly resigned. Putin became popular by recentralizing power, enacting financial reforms, collecting more taxes, and, with some success, intimidating the oligarchs and the regional governors. By 2004 he had done what some thought impossible—established extensive Kremlin control over the oil companies. Above all, his finance minister Kudrin had found a crude but effective way to tax up to 90% of their windfall profits.

Gustafson summarizes his analysis of how such reversals could befall Big Oil in these terms: "All that had happened (in the 1990s) was that the system of state controls had gone dormant. It retained large power over the industry in theory, but in practice that power became largely latent … (P)rivate ownership was established … in the spaces temporarily left unoccupied by a corrupt and penetrated state … There were two consequences … The first was the takeover by financial capital in the second half of the 1990s. The second was the subsequent reassertion of state power and its de facto recapture of the oil industry."

However, by 2002 the state had reasserted only limited controls. The private companies now accounted for a record 80% of oil production. Nonetheless, four contentious issues still dominated relations between the Kremlin and the oil barons. How legitimate had the privatization of the industry been, and shouldn't Russia have imitated other countries by building a national oil company? How should the state conduct its relations with the industry on key issues like the division of rents and the drafting of regulations? What role should foreign companies and capital play in Russian oil? And how should the movement and sale of oil through pipelines and an export regime be regulated?

Not surprisingly, Gustafson writes, the oil companies "defended their takeover of the state's assets as legitimate, fought the mounting attempts of the state to increase its take, and trumpeted their right to dispose of their assets and move their oil as they pleased, including through private pipelines and terminals." Supporting them were, broadly speaking, members of one of Putin's two main bases of political support, namely Yeltsin's extended family and key oligarch associates, such as Chubais and Abramovich.

On the opposing side was Putin's second support base, his former colleagues in the Soviet KGB, known as *siloviki* or "wielders of armed power." He had recently promoted these people to high positions. Their presumed leader was Putin's closest associate, Igor Sechin. They tended to resent people who had become wealthy or politically powerful in the 1990s, especially oligarchs. Ideologically, they inclined to statism and anti-Western nationalism. Putin needed to gratify them and thus bring the two groups into balance. This meant that he allowed them, within reason, to use their new-found influence to undermine the super-rich oil barons. As Gustafson says, "their motives were a complex mixture of sincere policy convictions, offended beliefs, political ambition and thirst for power, and, as time went on, cynical greed."

Such is the background that frames Gustafson's masterly analysis of the watershed episode in Putin's oil policy in the 2000s: the arrest of Mikhail Khodorkovsky in October 2003 and the subsequent nationalization of his oil company Yukos. Khodorkovsky was the most driving, ambitious, innovative, and politically reckless of the oil barons. A skilled financier, he determinedly learned the nuts and bolts of oil production, hired the best Western drillers and marketers, sent scores of bright young Russians to the West for training, manipulated the Russian parliament and media, engaged in generous philanthropy, and focused relentlessly on Yukos's bottom line, making it Russia's most valuable company. Internationally, he planned a major pipeline to China and gained the support of Beijing and the Russian prime minister. More daring still, he negotiated tenaciously with the US's Chevron over the terms of an outright merger. Finally, in 2003, he declared that he might go into politics, and, at a semi-public meeting, denounced government corruption and repeatedly crossed swords with Putin.

Gustafson's comment on all this hits the mark: "Practically everything he was and did … served to unite his enemies against him, while deterring those who might otherwise have sided with him." Among other actions, his enemies inspired the writing of a document about the danger of "an oligarchic coup," and got the attorney-general's office to issue threats and conduct searches of Yukos premises. Soon a Yukos colleague, and then Khodorkovsky himself, were arrested for alleged tax evasion. Later they received heavy sentences. In addition, the attorney-general arrested scores of other Yukos figures across Russia, causing further scores to escape abroad to London.

Reflecting on some broader issues that the Yukos case resolved to the satisfaction of the hard-liners, Gustafson notes an impressive list: "The idea of an autonomous oil sector … was decisively rejected"; the transportation of crude oil would remain a state monopoly; the power of state coercion in the business world was dramatically increased; and open resistance by the oil barons to the state's inexorably rising tax demands was abandoned.

Finally, the renationalization of oil took a giant first step when the small state company Rosneft acquired most of Yukos. This brought to fruition Putin's vision of a national oil champion. Gustafson devotes an absorbing chapter to Rosneft's rise, which happened in a strange and still murky way. At first, in 2004, Putin favored turning Gazprom into a national champion of both gas and oil, by presenting it with Yukos's prime asset. At the last minute, however, this was blocked by the Yukos-related ruling of an obscure judge in Texas.[5] Promptly, the agile leaders of Rosneft, including its chairman, the above-mentioned Sechin, stepped in and bought the Yukos asset. Nonetheless, the sale of Abramovich's oil company Sibneft to Gazprom in 2005 meant that Russia soon had two national champions, one for oil and gas and one just for oil.

At this point the process of renationalization halted, but only for a time. Seven years later, in October 2012, just after Gustafson's book went to press, Rosneft bought the major company TNK-BP. This meant that Rosneft's

5 This ruling concerned the legally suspect acquisition by Gazprom of shares in Yukos that had been held by foreigners.

share of Russia's oil production would rise to almost 40%, and the share of all state companies combined to over 50%, a fact that rendered out-of-date several statements in the book that the industry "is still largely privately owned." It seems uncertain whether the demands of the Kremlin's anti-nationalization faction that Rosneft must soon privatize some of its assets will eventually win the day.

Putin Rebalances His Power-base, But Then Eschews Reform of the Oil Sector and the Whole Economy, Thus Jeopardizing the Future of His Regime

In 2005–2008, in light of the recent growth in influence of his siloviki power base, Putin did some rebalancing to appease his Yeltsin-oriented support group. He dismissed the attorney-general, a silovik closely aligned with Sechin, he allowed an ugly public war between two siloviki clans to continue for three years, thereby discrediting them both, and, most important, he engineered the election to the presidency of a Sechin enemy, Dmitri Medvedev[6]. In my opinion, this last action was a bigger blow to the Sechin camp than Gustafson suggests. Certainly too, Putin, as premier, found the task of neutralizing Medvedev's attempted self-assertion and liberalism as president more irksome than he—though not perhaps Sechin—had expected.

This ensured that Putin would thwart Medvedev's desire to be re-elected to the presidency. Instead, he himself would return. In this context Gustafson lays out some competing "visions of Russia's future." As related to the oil industry, he sums up Putin's as saying "Trust the state and stay the course," and as holding that the present ways of doing things are the best. Also, too much nationalization is undesirable; foreign companies should be used mainly for their technological and business expertise; and they should not be allowed more than minority share-holdings. Exxon Mobil, BP, and Shell were duly engaged on these conditions.

As for Putin's professed support for modernization, skepticism permeates Gustafson's sophisticated analyses of the currently lagging efforts to reform oil taxation, and also of the deeply entrenched nature of the state's regulation of oil. His references to Putin's toleration or worse of large-scale corruption and the misappropriation of government money reinforce his skepticism, although the references are rather abstract. If he had given some examples from the rich materials compiled by Russian journalists at considerable personal risk, this omnipresent vice of Putin's system would have been more vividly conveyed.

Gustafson views Kudrin's competing vision of the future as advocating the development of a sound fiscal system and genuine market mechanisms. These must all be supported by democratic institutions and an independent judiciary.[7]

While Gustafson supports Kudrin's vision, he views Putin's with concern. The mass demonstrations launched by middle-class Russians in 2011–12 revealed a growing alienation from Putin's rule that could well spread in due course to wider sections of the population. Moreover, the economy remains that of a petro-state, i.e., largely undiversified, and the Kremlin's oil rents will probably soon decline. This will force cuts in services and thus provoke popular discontent and, probably, political instability, as—we can add with hindsight—popular enthusiasm for the annexation of Crimea and invasion of S.E. Ukraine turns to disillusion over the high economic and political costs of these adventures.

In conclusion, *Wheel of Fortune* is a powerful, original, elegantly written, and remarkably comprehensive analysis of a complex topic of far-ranging importance. Thus it is a reliable basis from which to analyze the major economic changes that Putin's rash adventures in Ukraine are beginning to force on him. Since oil exports to the West have begun what will probably be a steady descent, and since world oil prices have gone down by over 30% since June 2014, he will have to try to make further sales to the hard-bargaining Chinese. At the same time, the technical support currently provided by the foreign oil companies has been sharply compromised by the Western decision to punish Putin for the recklessness of his foreign policy.

About the Author

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6 On all this, see my as yet unpublished 60-page article, "The Silovik War and the Nature of the Putin Regime".

7 Similarly, the late Yegor Gaidar, in his recently published history of economic growth, Russia: A Long View, MIT Press, 2012, p. 377, advocates "a regulated liberalization of the regime, the restoration of real freedom of speech, the separation of powers, an independent judicial system, an open mechanism of government decision-making, and an effective war on corruption".