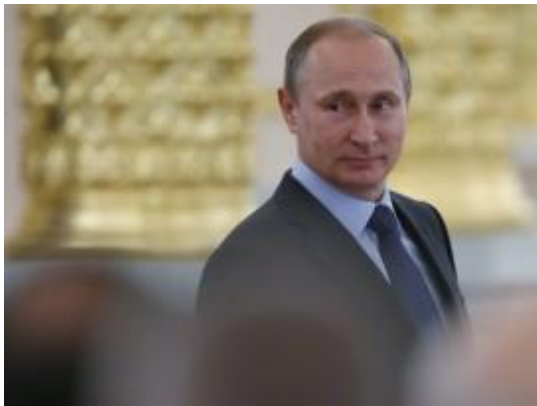


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Nick Butler

Russia is in trouble as energy prices fall

Nick Butler [Author alerts](#)  Aug 09 21:00 120 comments

President Vladimir Putin © Getty Images

With oil prices back down to \$50 a barrel for Brent crude, a falling gas price and its share of the European energy market declining, the Russian economy is in real trouble. The situation is dangerous because the problems cannot easily be corrected. The risk is that the economic problems could lead to political instability both within Russia and around its borders.

Anyone wanting to understand the historical context for what is happening in Russia should read *Restless Empire* a newly published book written around a series of maps which take go back to the emergence of the Slavs some 5000 years

BC. The book, edited by the late Ian Barnes who sadly died before publication, is beautifully presented and free of the biased commentary so often associated with histories of Russia. The maps in particular are fine examples of immaculate design applied to the presentation of complex data. I only wish there were more maps, and in particular more on the production and trade in energy that dominates the modern Russian economy.

It is that dominance which is the cause of the current problems. The facts are simply stated:

- Energy is the largest single sector in the Russian economy – accounting for a quarter of total gross domestic product this year, down from a third two years ago.
- Energy exports account for about 68 per cent of Russian trade.
- Oil and gas revenues provide half the Russian government's official budget and an uncounted but substantial amount of the unofficial funding that supports the country's power structure.
- As a result of the fall in oil prices, the Russian economy is predicted to decline by 3.5 per cent this year, with oil export revenue down by \$95bn, after suffering a fall of \$174bn in 2013.

Russia's immediate problem is not sanctions imposed by the west or the continuing conflict in

Ukraine. The issue is economic. Most of Vladimir Putin's 15-year reign (as president and as prime minister) has coincided with strong energy prices and growing production of oil and gas. The resulting revenue has enabled the Kremlin to keep most people happy – businessmen, the military, the middle class of Moscow and St Petersburg and even most of the wider population. But the sun never shines for ever. Too little has been done to prepare for the current downturn. The Russian economy has not been diversified and although there is a reserve fund that can provide some cushion against the fall in revenue the amounts involved are small and will soon run out if current prices persist.

As reported in the FT last week, Gazprom is set to produce less gas this year than at any time since the fall of the Soviet Union." The company's market share is falling and according to analysts at Sberbank its revenue, year on year, is expected to drop by almost 30 per cent this year."

Gas-to-gas competition fed by the increased flows of liquified gas (LNG) has broken the traditional link between gas and oil prices and is changing the structure of a market the Russians had taken for granted. After years of cozy interdependence with the European utilities, the company's trading activities are under sustained attack by the competition authorities in Brussels.

The oil story is no better. Russia exports about 6m barrels a day (mbd) but each one is now worth only 40 per cent of the revenue achieved two years ago. After a small surge in the spring, the world oil price has now fallen back to \$50 a barrel. None of the recent political and economic developments around the world, from the rehabilitation of Iran to the Chinese downturn, offer the prospect of an increase anytime soon. The surplus of supply over demand is considerable. Inventories have risen by 2.2mbd during the first half of 2015, according to the US Energy Information Administration and are predicted to rise by another 1.2mbd in the second half of the year. These official stock numbers probably understate the amounts actually held both by producers and by some importing countries. The market is saturated.

Sanctions and the associated isolation of Russia because of events in Ukraine may not be the immediate cause of the problems the country faces but they compound the longer-term difficulties. Russia needs to replace much of its existing production base and to expand its oil and gas industry into new regions if output levels are to be maintained. International companies may be happy to sign up to new long-term "alliances" with Gazprom and Rosneft in order to protect their existing asset base and current cash flows but they are not rushing to pour in new money while sanctions remain in place.

At the same time, fears about the future of the Russian economy are encouraging a dramatic outflow of capital. Many of those who have done well in the last decade fear that in hard times Mr Putin could expropriate assets in order to keep things going. According to some estimates, the exodus of capital since the latest phase of the Ukrainian crisis began in November 2013 could amount to \$300bn by the end of this year. Some physical assets cannot be moved but cash and wealth in other forms certainly can. No one is doing more for London estate agents at the moment than Vladimir Putin.

The situation is dangerous because the options for the Russian government are so limited. The oil and gas markets are being shaped by forces that neither Mr Putin nor anyone else can control. The downward cycle could take years to play out. The dispute over Ukraine is an obstacle that could be removed but even a complete and amicable settlement there would not restore Gazprom's market share in western Europe. The deals to sell gas from east Siberia to China and others make sense but will not make money for another decade.

The real risk is that economic discontent will force either the existing Russian government or its replacement into a harder political stance. As the maps in Barnes's book show Russia has spent most of its history in conflict with one neighbour or another. War, as on numerous past occasions, could provide a nationalistic distraction from the grim economic realities. In many ways, the last 25 years in Russia have been a period of relative stability. But there is no guarantee that that situation will last. Mr Putin will remember all too well that one of the major reasons for the fall of the Soviet Union at the end of the 1980s was the collapse in energy prices. If anything, Russia is weaker now than it was then. Indeed, as Dominic Lieven says in a brilliant introduction to Barnes's book: "Russia is now weaker than it has been at almost any time in the last 300 years."

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