The Unbearable Lightness of Petrodollars

Konstantin Sonin

The second term of Vladimir Putin's presidency began under very favorable economic conditions. High oil and gas prices, both key assets of the Russian export industry, permit his government to boost Russian living standards with direct money transfers and engage in structural reforms at the same time. However, as the experience of other countries suggests, governments do not hurry to introduce reforms when the economic climate is looking good. In other words, why toil too much if everything is alright? Political leaders rest on their laurels, while the voters (if we are speaking about democracies) do not try to wake them up, since they see no reason for concern. In such situations the authorities pay little attention to expert warnings about the dangers of chasing short-term advantages and postponing reforms. Harvard University economists Jeffrey Sachs and Andrew Warner attribute this to the public's false sense of security that emerges during periods of affluence.

The 'contentment-with-prosperity' effect can be observed both in imperfect democracies and in truly authoritarian states. No dictator will conduct painful reforms if the population does not demand them.

And vice versa: as soon as a period of austerity arrives, reform expectations grow in the society alongside a desire to replace its leaders. Prof. Danny Roderick from Harvard University states that

---

Konstantin Sonin is Professor at the New Economic School and leading economist at the Center for Economic and Financial Research (CEFIR) in Moscow.

as a crisis emerges, the advantages and losses of any policy acquire a new dimension. Democratic leaders react to such problems faster and refrain from any overly radical moves. However, the less democratic a country is, the later its leaders will respond to the situation. As a result, their reactions are usually quite harsh.

WHAT ARE THE OBSTACLES TO GROWTH?

There is a standard set of reasons why the abundance of natural wealth impedes economic growth (which is a widespread trend). These include the struggle for natural rent between different groups. Next, there is what is known as 'Dutch disease' when the value of a country's currency rises, thus making manufactured goods less competitive with other nations. Finally, there is the inherent volatility of the world commodities markets, which especially hurts economies with non-diversified exports. All these factors are greatly conditioned by government policies.

Savings and investment surveys show that countries rich in natural resources are unable to sacrifice short-term political gains for long-term economic efficiency. They prefer to channel revenues into wage increases instead of investing in education or new technologies.

The records of many countries prove that a sudden emergence of an additional income source lets the government postpone long-pending reforms. Many such examples are discouraging – Sudan, Nigeria, Venezuela, Algeria, Libya and Azerbaijan. Oil revenues in those countries enabled their governments to protect the local industries from foreign competitors far longer than the rules of economic efficiency required. In resource-rich Central African countries, such as Niger, Mali and Chad, the main problem was a very low level of savings and, therefore, investment. The quality of investment left much to be desired, too. In Nigeria, for example, the government funneled oil export revenues into industrial development, but it did it so inefficiently that, even despite an annual six-percent growth rate of investment during two decades, the national industry remained stagnant. In Saudi Arabia, the ineffective application of oil export revenues brought about a serious imbalance on the job market: in 1998, almost 90 percent of the local population was employed in the state sector.

There is a positive example, however. Norway invested surplus oil export revenues in education and a stabilization fund. Yet, Oslo, too, has problems that are related to its oil market orientation. Norwegian exports have become frozen at about 40 percent of the country's gross domestic product. This is a very good figure by international standards, but it was attained before oil revenues started pouring into the economy. It means that oil has not increased the rate of exports, but has only replaced some of the traditional export items.

POSTPONED TRANSFORMATIONS

Russia can learn a lot from the example of Mexico, which has a similar political system. It is a big federal state with a single megalopolis that concentrates the financial wealth of the country. For almost 60 years the country was ruled by one party, although some principles of elective democracy were still observed. For example, neither presidents nor congressmen, elected in a non-competitive environment, were allowed to remain in office for longer than a fixed term.

In the 1950s, the Mexican economy grew at a very fast pace, but after the import substitution policy had exhausted its potential, the country felt the need for reforms. At that very time, there arose a favorable situation on the world commodity markets. After the oil price hikes of 1973, Mexico found that exporting oil (which had previously been almost completely consumed on the domestic markets) was the simplest and quickest way of enriching the nation. As former president José López Portillo, who ruled at this time, stated: "Oil is what secures our independence and compensates for our drawbacks." The inflow of petrodollars brought cheap foreign bank loans with it. In the period from 1976 to 1979, more than half of all loans given to the developing world went to five countries, including three oil exporters. Obviously, any country which is suddenly inundated with wealth must not indulge in borrowing sprees, but rather save money or pay back its previous debts. But is there any politician who would dare tell his fellow citizens that the feast will end some day?

In the early 1980s, a global economic slump was followed by a drastic dive in the price of oil. In 1982, a new candidate from Mexico's ruling party, Miguel de la Madrid, ran for the presidency under a slogan for change. His program of reforms was aimed at reducing state interference in the economy, liberalizing trade, and carrying out privatization and deregulation. The reforms, which should have been carried out ten years before, were successful, although very painful.

Alexei Kosygin

Russia also experienced periods when a sudden emergence of additional revenue sources let it postpone long-awaited reforms. The most vivid examples are the reforms that were proposed by Soviet Prime Minister Alexei Kosygin. Launched in the mid-1960s, after a new team of Soviet leaders came to power, the reforms were actually a reaction to a decrease in living standards which had triggered strikes and protests in the country a few years before. The reforms were intended to increase the effectiveness of the centrally planned economy by stimulating economic agents. Among other measures, the industrial enterprises were anticipated to independently manage part of their profits. However, in the late 1960s, rich oil and gas fields were discovered in Western Siberia. As a result, the much-needed reforms were stopped and later shelved, as the Soviet economy was flooded with petrodollars. The consequences of stalling the reforms were felt soon enough, with Soviet agriculture hit the hardest. As the country was now able to purchase grain from abroad, there was no need to reform the national system of collective and state farms (*kolkhozes* and *sovkhozes*). As a result, in 1974-1985, the agricultural growth rate in the Soviet Union was far below the figures of the developed countries, and almost three times below the world's average. By the mid-1980s, the Soviet Union ranked 90th in the world in grain production and 71st in potato production.

A new attempt to reform the country was made 15 years after the beginning of Kosygin's reforms, in the first few years of Mikhail Gorbachev's perestroika (restructuring) policy. By that time, the crisis of the Soviet economy had become all too evident, especially after oil prices plummeted in the early 1980s. A top official at the Soviet State Planning Committee said in 1988 that "if we had not discovered the Samotlor [oil field], we would have been forced to start perestroika 10 or 15 years before." Meanwhile, it can be debated what would have become of the country had the Kosygin reforms continued. Could they have saved the Soviet Union? Most likely, the Kosygin government would have been forced to face the fundamental issue of ownership, in much the same way as Gorbachev did. Yet, there is the possibility that the Soviet economy would have entered the period of radical reforms in a far less decrepit state than it did in the late 1980s.

The international community has a very limited ability to influence the oil-exporting countries and encourage radical reforms there.

Generally speaking, the international community has a very limited ability to influence the oil-exporting countries and encourage radical reforms there. Experts of the Carnegie Endowment for International Peace pointed out that the international community, as a rule, avoids pressuring the oil producers. Such a policy was pursued vis-à-vis Iraq until Saddam challenged the world in 1991 by occupying Kuwait. Saudi Arabia is still free from any excessive Western pressure. In Sudan, the government received the right to extract oil only after it concluded an agreement with the opposition forces operating in the country's oil-rich regions. According to the agreement, Khartoum cannot use oil revenues to beef up its military potential, that is, to increase allocations for the struggle against the opposition. Nevertheless, the country's defense spending soon doubled, and the international organizations that were the guarantors of the agreement preferred not to interfere, although they had long viewed Sudan as a potential 'rogue nation.'

OIL AND DEMOCRACY

Moisés Naím, Editor of the *Foreign Policy* magazine and Venezuela's former minister of trade and industry, knows very well the specificity of the development of the naturally rich countries. He asserts that not a single 'petrostate' has been able to make oil into a source of prosperity for the majority of its population. "When oil revenues flood a nation that has a weak system of democratic checks and balances, dysfunctional politics and economics ensue," Naím wrote in *The New York Times* (December 4, 2003). "A lot of oil, combined with weak public institutions, fuels poverty, inequality and corruption. It also undermines democracy."

The government of a country where the budget is mainly formed by oil revenues feels no need to actively collect taxes from numerous small and medium-sized businesses and, therefore, no need to stimulate their growth and heed their political demands. This situation provokes growing inequality, which is the curse of all naturally rich countries, and hampers the political activity of the middle class, the basis of democracy.

Leonard Wantchekon of New York University discovered the following correlation: "A one percent increase in [a country's] resource dependence as measured by the ratio of primary exports to GDP leads to a nearly 8 percent increase in the probability of authoritarianism."

Even in democratic countries, reliance on oil revenues bolsters centralized power, since oil, as a strategic resource, often falls into the hands of one state-owned company. In weak democracies, it may lead to the establishment of a truly authoritarian regime, as happened in Nigeria where the share of oil in the GDP grew from one percent in the 1960s to 90 percent in the 1990s. Only well-developed democracies with strong civil and political institutions are protected against such a scenario.

In Norway, for example, the growth of oil revenues produced a totally opposite effect. For the previous five decades it had been ruled by one (Social Democratic) party; since 1981 it has been alternately run by Social Democrats and Conservatives.

Dependence on the export of natural resources may have grave economic consequences; the higher the dependence, the higher the risks. Likewise, failures of economic policies in the authoritarian states are far more catastrophic than in democratic countries.

Windfall incomes and the strengthening of the state (similar to the processes that are under way in Russia now) are prone to one more danger – the flagging responsiveness of the political system to the demands of the citizens. The situation may arise where the citizens feel the need for reforms, but the imperfections of the political mechanism bar them from exerting sufficient pressure on the politicians.

The above considerations suggest an unfavorable conclusion for Russia: resource-rich countries have less chance to become full-fledged democracies than other states. On the other hand, the experience of other resource-rich countries does not allow one to measure the probability of Russia becoming an authoritarian state.

Russia is a "normal country," as Andrei Shleifer and Daniel Treisman described it in *Foreign Affairs* (March/April 2004). It is normal in a sense that its crime level, media independence, and life expectancy are almost the same as in other states at a similar level of development. The trouble is that, from the point of view of its democratic stability and the ability of its political system to correct its own flaws, Russia is a borderline state. It is too rich for a Chinese or Korean-style modernization – and too poor to resist politicians' attempts to embark on that path.