

The price of oil and Soviet/Russian aggressiveness

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There has been much speculation about the reasons that prompted President Putin's increasingly hostile reaction in 2012-13 to the negotiations on an EU-Ukraine association agreement. The chain of events is well known. Russian pressure led the then President of Ukraine, Viktor Yanukovich, to decline to sign an Association Agreement with the EU, which sparked the Euro Mайдan in Kyiv. These protests were then used as a pretext for the annexation of Crimea and the support for anti-Maidan rebels in the Donbass region, which was then followed by an outright, even if covert, invasion.

It is often argued that Russia is reacting to a perceived encroachment of the EU/NATO on an area that it considers its own neighbourhood (and President Putin said as much during his annual end-of-the-year press conference in December). However, history suggests that the underlying reason for Russian aggressiveness is simpler: A decade-long period of a steadily rising oil prices (and that of other raw materials) created a feeling of strength, bordering on invulnerability, which made Russia more assertive, and ready to use any opportunity to deploy its military power. The abrupt reversal of this trend since the summer of 2014 will thus be the harbinger of a much less aggressive Russian stance as long as oil remains at present levels.

One needs to go back only 40 years to find a similar development. The 1970s had seen a similar increase in Soviet assertiveness which culminated in the invasion of Afghanistan at the very end of the decade. This came also at the tail of a decade of sharply increasing oil prices (and Soviet oil production). Between 1965 and 1980, the value of Soviet oil production went up by a factor of almost 20 (from about \$20 billion annually in 1965 to almost \$400 billion in today's purchasing power in 1980). This was due in large part to the oil price increases following the first oil embargo. But there was also a large increase in Soviet oil production. In the 1960s, Soviet oil production had been lower than that of the US, but thanks to the discovery of some large fields it became much larger by 1980. This combination provided the main growth elements of the Soviet economy, making its regime much more credible, and not only in the eyes of its own population. The resulting increase in the real resources available to the Soviet elites was spent to a large extent on the military budget, allowing the Soviet Union to become a much more credible threat. The increase in relative, and absolute, economic and military strength emboldened an ageing (and therefore naturally

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not adventurous leadership) to become more assertive abroad. The invasion of Afghanistan appeared also at first sight to be an improvised reaction to a local development (a putsch in Kabul). The parallel to Putin's reaction to the Euro Mайдan is instructive. In both cases, a seemingly low-cost opportunity was seen as yielding a large strategic gain, at least in the short run.

The figures in the Annex shows the value of Soviet and Russian oil production in constant dollars over the last half century. It is apparent that high values are associated with foreign adventure, whereas Russia was much more cooperative when the value of its oil exports was low.

At the time of the Soviet take-over of Afghanistan, it was often argued that this was a defensive reaction to the perceived encirclement of the Soviet Union. This motive might have been latently present for a long time; but without the economic and military strength coming from higher oil prices the Soviet Union would most probably not have acted on it.

The end of the Afghan adventure is now known, but this was not clear at the time, when it was interpreted as a major defeat of the West. It is often forgotten that a major element of the Soviet defeat in Afghanistan was the weakening of the economic base of the Soviet Union as oil prices fell throughout the 1980s, cutting the value of Soviet oil production to one-third of its peak level. This led to a period of extreme economic weakness in the entire Soviet space and was a key factor (but of course not the only one) in the dissolution of the Soviet empire.

The 1990s then saw a protracted period of low oil prices and production during which time Russia was absorbed by its own internal problems given that the value of its oil production had plummeted to less than \$60 billion and did not object to EU (or even NATO) enlargement to the East. This changed gradually during the early 2000s as the oil price (and production) recovered in Russia, again strengthening the economic base of an increasingly autocratic leadership. The complaint that the US and its European allies had somehow given a pledge not to expand NATO eastward came mostly after the fact as oil prices recovered from their low of \$10/barrel in 1999-2000.

The steady upwards trend in oil prices during the early 2000s culminated in a first peak of the value of Russian oil production in 2008 and the invasion of Georgia. The oil price collapsed briefly during the Great Recession of 2009, but it recovered quickly, and the value of Russian oil production reached another peak in 2012-13 when the value of its oil production topped \$500 billion. These were also the years during which the Russian position on the EU-Ukraine Association Agreement hardened. The negotiations on this agreement had been going on since 2010 without eliciting any particular reaction from Russia. And so, the objections suddenly voiced by Russia when the agreement was close to being concluded appeared to come out of nowhere for the EU side.

The swings in the oil price provide a telling background to the swings in Russia's attitude towards its 'near abroad'. A latent resentment is expressed in a more aggressive form, including military means, when the resources are available. Moreover, a high oil price crowds out other export sectors that would be interested in open markets.

The Afghan adventure was followed by a longer-term decline in oil prices. The very recent slide in the oil price suggests that history is about to repeat itself. At a price of \$60/barrel, the value of Russian oil production will return to the levels last seen about 10 years ago, when Russia was much less aggressive than it is today. This suggests that a stalemate in the Donbass is more likely for the time being than an outright offensive aimed at occupying the remainder of the region and establishing a land corridor to Crimea. The Nova Russia project has no chance with oil at current prices.

The EU and US sanctions, which seemed to constitute only a pinprick a few months ago, now appear to have inflicted much more serious damage as the sudden slide in oil prices is compounded by financial-market turmoil. Financial markets will find a new level for the exchange rate and then calm down again. What will stay will be a considerably weaker Russian economy on which the sanctions will impose a much greater burden than appeared to be the case with oil above \$100/barrel.

A new, less aggressive, Russia is likely to emerge with the new equilibrium in the oil market.

Annex

Figure 1 shows the annual volume of Soviet and later Russian oil production multiplied by the price of oil in real terms.

Figure 1. The value of Russia's oil in constant USD

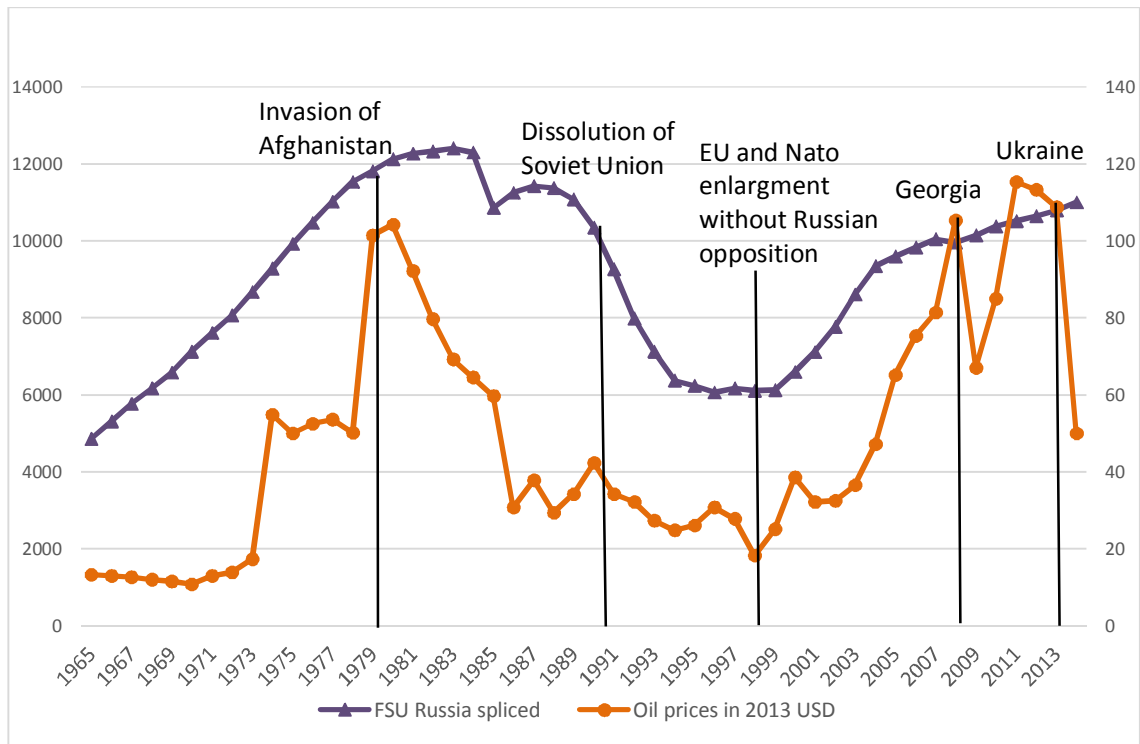


Source: BP Statistical Handbook.

Figure 2 shows the volume of Soviet/Russian oil production (blue line, left-hand scale) separately from the real price of oil (orange line, right-hand scale).

It is apparent that movements in the price have been highly correlated with production, amplifying the impact of price movements on the value of output. This is what one would expect: as the price of oil diminishes, production will be reduced. However, there have also been political amplifiers: the chaos following the collapse of the Soviet Union (partially related to lower oil prices) led to a reduction in production. The introduction of market reforms, reinforced by higher oil prices led to a recovery of production during the 2000s. The next years are likely to see a repetition of this correlation as the combined effect of the sanctions (reduced availability of capital and technology) and the less market-friendly environment in Russia will probably lead to lower production volumes.

Figure 2. Source of the value in Soviet/Russian oil production



Source: BP Statistical Handbook.