Pointmaker

DEPLOYING THE SAUDI OIL WEAPON AGAINST RUSSIA

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SUMMARY

- The West appears powerless to restrain President Putin's intervention in the Ukraine; and possibly in the wider region.
- However, the West could target a crucial vulnerability of Russia today: its general economic weakness and its heavy dependency on oil revenue. It has been estimated that, if the oil price fell below $90/barrel, Russia would suffer serious economic pain (the current oil price is about $103/barrel).
- This collapse in oil prices could only be achieved by encouraging Saudi Arabia increase oil production substantially, thereby deploying the "Saudi oil weapon". This has been successfully used on at least two previous occasions: against the West following the Yom Kippur war and against the USSR following its invasion of Afghanistan.
- Despite the self-inflicted economic damage, the Saudis would have two reasons why they might do this:
  - it would give Saudi Arabia a rod with which to punish Russia over Syria;
  - it would enable close relations to be re-established between the US and Saudi Arabia following their dispute over US-Iranian rapprochement.
- In addition, Saudi's huge financial reserves (at least eight times greater than Russia's) and its substantial foreign investments would enable it to weather a lower oil price without too much pain.
- A lower oil price, and a reduced security risk, would also give a shot in the arm to global economic demand (itself a further benefit for Saudi Arabia).
- The Saudi oil weapon – or at least the threat of its deployment – could therefore encourage Russia to realise that further intervention is not in its self-interest.

1. INTRODUCTION

Russia's aggression towards Ukraine and now perhaps Moldova presents a difficult challenge to the West. Putin's view of the world is hard for Western leaders to comprehend, and it may well be that standard economic sanctions will make little impression on him. Russia needs to be stopped in its tracks before it invades any further part of the Ukraine and then threatens the Baltic states, and Poland.

In the face of this military aggression European states are offering little beyond rhetoric and nugatory measures against a handful of Russian individuals. It is as if Russia's long-cherished ambition of reducing Europe to the western projection of the Eurasian landmass (or Finlandisation) is being realised through a combination of trade, reliance on Russian energy supplies and Europe's pacifist tendencies.

There is an alternative: to use falling oil prices to push back at the Russian Government in concert with other economic sanctions; Russia's shaky public finances only hang together with an assumed oil price of over $90/barrel in the next few years. Prices some way below $90/barrel would bring severe political and economic consequences for Russia.

The oil basket price is already showing weakness at $103/barrel, with analysts predicting a $10 to 12$/barrel drop in the coming months as things are. On 12 March, President Obama authorised the release of five million barrels from the Strategic Petroleum Reserve (SPR), which suggests that the US Government is well aware of the power of oil prices. Further SPR releases, combined with Saudi production increases, could have a severe impact on the Russian economy and the rouble.

The Saudi oil weapon was an effective measure in the 1980s in combination with initiating an arms race and providing assistance to the Afghan mujahideen. Now, as in the 1980s, Saudi Arabia would be the crucial partner in this. Considering the situation in Syria, the Saudis are likely to be amenable to the idea. The Saudis should be able to weather the low prices themselves without too much pain, particularly since the shift in prices would be planned and could be 'feathered' or reversed by the Saudis and their partners.

The scheme could also have two attractive side effects: it could revive the US-Saudi partnership (battered by the rapprochement with Iran); and it could give a shot in the arm to global economic demand.

2. THE OIL WEAPON IN THE 1980s

The 'Saudi oil weapon' is best remembered by the public in the Western world for the high prices inflicted after the Yom Kippur war in 1973, which lasted into 1974. The embargo inflicted considerable economic pain on the West, split the NATO allies and made Nixon extract territorial concessions from the Israelis. It appeared, in other words, to have been effective.

It was used again, less famously but perhaps even more effectively, against the USSR in the 1980s. Overall, the Reagan administration's measures against the USSR were intended to weaken the system and hasten its demise, without provoking an armed confrontation. It is hard to argue that this was anything but a success. The measures took three main forms.

First, after the Soviet invasion of Afghanistan in 1979 the Saudi and US Governments embarked on close covert co-operation. With assistance from Pakistan they channelled funds and weapons to the mujahideen, helping to mire the Red Army in a protracted insurgency and demoralise the civilian population of the USSR.

Second, the US drew the USSR into an arms race that the latter could ill afford. A central element of this was the 'Star Wars' Strategic Defence Initiative (SDI), which may have been in part a bluff intended to overstretch the Soviet military R&D spending.

These two measures helped to enfeeble an already weak system by imposing wasteful spending.

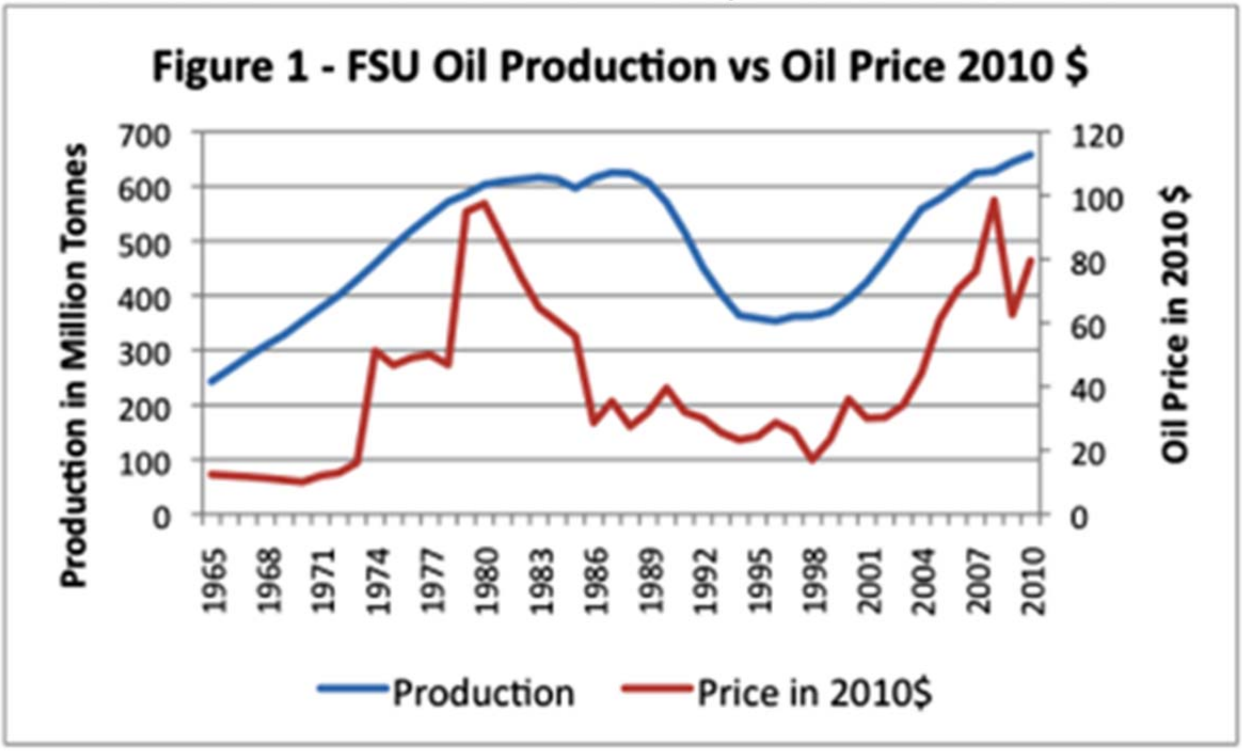
The third measure – the Saudi oil weapon – struck at Moscow's hard-currency revenue stream. After the invasion of Afghanistan in 1979, the Saudis started to open up the oil taps, causing oil process to plummet (see chart below). Soviet oil production then went into a sharp decline from 1988, mostly for internal reasons. The combination of these two factors – falling world prices and falling Soviet production and export – starved the system of hard cash for food imports.

This effect has been set out thoroughly by Yegor Gaidar, Prime Minister of Russia in 1991-1994, in an excellent paper entitled, The Soviet Collapse: Grain & Oil (AEI, 2007). He describes the Saudi intervention from the mid-1980s:

The timeline of the collapse of the Soviet Union can be traced to September 13, 1985. On this date, Sheikh Ahmed Zaki Yamani, the minister of oil of Saudi Arabia, declared that the monarchy had decided to alter its oil policy radically. The Saudis stopped protecting oil prices, and Saudi Arabia quickly regained its share in the world market. During the next six months, oil production in Saudi Arabia increased fourfold, while oil prices collapsed by approximately the same amount in real terms. As a result, the Soviet Union lost approximately $20 billion per year, money without which the country simply could not survive. The Soviet leadership was confronted with a difficult decision on how to adjust.

Gaidar describes three options in response to this crisis: dissolve the empire in Central Europe, stop grain imports or cut military spending:

Former Soviet Union Oil Production and Consumption, based on BP Statistical Data.



Unable to realize any of the above solutions, the Soviet leadership decided to adopt a policy of effectively disregarding the problem in hopes that it would somehow wither away. Instead of implementing actual reforms, the Soviet Union started to borrow money from abroad while its international credit rating was still strong. It borrowed heavily from 1985 to 1988, but in 1989 the Soviet economy stalled completely.

3. THE SITUATION TODAY

Russia today is not the USSR, but it remains heavily dependent on oil revenue. It is also facing budget shortfalls even at current oil prices. On 3 December 2013, Reuters issued a report with the headline, 'Russia faces budget shortfalls, risks erasing oil savings – document':

Russia will face huge fiscal shortfalls in the next two decades unless it cuts spending, and it could wipe out its oil savings in as little as three years, according to sources and a strategy document obtained by Reuters.

Russia's funding gap could reach $300 billion between 2017-20, the Finance Ministry's budget strategy to 2030 shows. That is three times the current value of the Reserve Fund, a rainy-day fund of windfall energy revenues…

…Russia's budget faces major challenges: lower-than-expected privatisation proceeds and difficulty collecting taxes. Tax shortfalls may come to $50 billion in the next three years, according to the strategy.

The strategy assumes relatively high prices for oil, Russia's main exports, of $90 to $110 per barrel between 2013-2030. Oil and gas's share of GDP will decline by half, from 20 percent of GDP this year to 10 percent, however.

If prices fall significantly below $90/barrel, Russia will therefore face considerable pain. A sustained fall in living standards could offset the feeling of pride in 'Great Russia' that Putin's core supporters are feeling now, and could threaten his re-election in 2018. The policy of military aggression also imposes increasing defence spending, which will further squeeze the budget.

It is generally accepted that Saudi is the sole swing producer in the world oil market, although nowadays it chooses not to use its power in the way it used to. OPEC is currently moving towards cutting production to compensate for flat demand and increasing global supply, something Saudi Arabia has resisted.

Clearly, if Saudi were to open the taps, its Government would need to be convinced of the case for doing so. It would have the valuable side effect of stimulating the global economy in its recovery from the financial crisis, since healthy exports markets are in Saudi's long-term interests. The Saudis may be able to bring the UAE and Kuwait along with them, but it is neither desirable or likely for production increases to be pushed through OPEC.

The direct Saudi interest in this could be twofold, given that it can be assumed the Saudis have little interest in Ukraine.

First, at an opportune moment for Saudi to look for new policies in Syria, it would give Saudi Arabia a rod with which to punish Russia over Syria. Bandar bin Sultan, head of GID (Saudi foreign intelligence), is now reportedly being marginalised in Riyadh over his active support for Sunni extremists in Syria, and for pulling Saudi away from the US. The interior minister Mohammed bin Nayef, who enjoys a warm relationship with President Obama, is now reported to be in the ascendant.

Bandar has also tried to improve relations with Russia by dangling large arms purchases. This policy can only be seen as a complete failure.

As well as giving the Saudis a way to strike at Russia, the oil manoeuvre would give Riyadh a way to re-establish its close co-operation with the US and patch up the dispute over US-Iranian rapprochement.

4. HOW IT WOULD WORK

While the Soviet state was perpetually vulnerable to the 'resource curse', its leaders were largely unaware of the peril. Gaidar writes:

In the 1970s and early 1980s, the Soviet leadership, however, was not intellectually prepared to heed lessons from the School of Salamanca. The shortest quotation about the intellectual capacity of the Soviet leadership came from the Politburo minutes: "Mr. Zasiadko has stopped binge drinking. Resolution: nominate Mr. Zasiadko as a minister to Ukraine."

Although the Kremlin today is no intellectual hothouse, it is true that Putin is acutely aware of the combination of factors that cause the USSR to collapse – an event he regards as, 'the greatest geopolitical tragedy of the Twentieth Century'. Putin would be likely to understand both the true origin and the seriousness of the implications for Russia and for his own re-election in 2018.

In the best-case scenario, the result would be that Putin ceases to threaten eastern Ukraine (and perhaps to lessen his support for Assad in Syria, although his diplomatic successes there make this a harder proposition).

It would not be the intention to wage an open-ended economic war on Russia, but rather to halt its military aggression towards neighbouring countries. Oil prices cannot be controlled as if from a dial on a dashboard, but should Russian policy become more conciliatory, then the Saudis could start to reduce supply and ease the pressure on Russia.

5. RISKS

Just as Russia has come to resemble a petro-state, so too could plummeting oil prices also pose problems for the Saudis. In the worst case, this could have implications for Saudi internal security. On 23 December 2013 Bloomberg reported:

Saudi Arabia derives about 90 percent of revenue from oil sale. This helped the nation's central bank boost its net foreign assets to a record 2.7 trillion riyals in October, according to central bank data.

The government uses conservative crude price estimates when planning its budget. This year it needed oil in the late $70s per barrel, Sfakianakis [the chief investment strategist at MASIC in Saudi Arabia] said. The break-even price should be about $85 per barrel next year, given actual spending for 2013 and announced outlays for 2014.

So the break-even price for Saudi's budget is only $5/barrel below Russia's. However, there are three mitigating factors.

First, the Saudi Government would be able to plan in advance, since it would be the originator of the fall in prices. Second, Saudi Arabia has vastly deeper financial reserves than Russia. Cash reserves alone are estimated to stand at $800bn in 2014 (compared to about $100bn in the Russian Reserve Fund), aside from huge international investments. Third, the more fundamentalist parts of the Saudi population are likely to accept the policy and any associated disadvantages if they see that it helps to prise Russian support away from Assad.

A separate risk is that Putin responds in an unexpected way. Instead of becoming more conciliatory over Ukraine, he might ratchet up his aggression, perhaps threatening other parts of Ukraine or the Baltic states. He may calculate that the West wants to avoid conflict at all costs, and therefore he can in return make more security threats to counter the economic threat to Russia. In his mind, the West would back down first.

While this would not be ideal, to refrain from using the oil weapon on these grounds would mean accepting that any direct measures against Russia are too costly or risky. In the longer term, such a policy may be the most costly of all, since Putin will believe that there are few if any limits on his behaviour, making an eventual Russia-NATO conflict more probable.

Finally, Russia has an energy weapon of its own, of course, which is Europe's reliance on Russian gas supply. When Yanukovych rebuffed the EU in November, Gazprom announced a discount for Ukraine. Now, predictably, Gazprom is threatening to stop supplies to Ukraine on the pretext of unpaid bills. Overall about 30% of Europe's gas comes from Russia, but some states, such as Bulgaria and the Czech Republic, are 100% reliant, and overall the exposure is far higher in Central & Eastern Europe than in Western Europe.

Fortunately, the approach of spring makes the threat of supply disruptions less alarming. Moreover, the increasing supply diversity and interconnection in the Central European gas system means that even by winter 2014/15, substantial measures can be taken to offset threats to supply. Meanwhile if Russia chooses to cut the flow of gas westwards, it will see yet lower revenues from energy and yet weaker exports.

Taken together, these measures could make it clear that it is in Russia – and Putin's self-interest to refrain from further intervention. The price seems low; and the possible gains, for peace and the global economy, enormous.

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