

Why Higher Oil Prices Should Worry Russia

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The Economic Development Ministry lowered its projections for Russia's economy, downgrading growth to only 1.8 percent for 2013. But the Urals crude has traded above its forecasts this year, and higher oil prices could provide an economic boost since oil and gas account for roughly 75 percent of Russia's exports and almost half of its budget revenue. The worrisome question is what happens beyond this year.

The latest oil price increase was triggered by fears of a U.S. missile strike on Syria, but even if it doesn't occur, the region will remain turbulent and the risk premium, which has pushed oil prices to a five-year high, will endure. Potential supply disruptions are attracting speculators, who are flush with liquidity provided by major central banks, especially the U.S. Federal Reserve. This liquidity has already created a bubble in U.S. stocks and could infect the oil market. With or without an attack on Syria, oil prices could rise to about \$145 per barrel during the rest of 2013.

Over the past three decades, the world has developed a bubble economy, characterized by runaway booms and increasingly severe busts. Oil prices went through a boom-bust cycle in 2008-09, plunging by 60 percent in a few months.

The subsequent recovery in oil prices occurred because of strong growth in emerging markets as China continued to industrialize, while agriculture and mining in Latin America, Australia and Africa stoked the Chinese economy. In China alone, 50 million additional private cars hit the road over the past five years, putting upward pressure on oil prices.

This extra oil demand was in part a by-product of U.S. financial bubbles. China grew as fast as it did because Washington ran fiscal deficits and subsidized purchases of Chinese goods by U.S. consumers. By constantly printing money, the Federal Reserve kept both interest rates and the dollar artificially low. Since oil is priced in dollars, when a country's currency goes up against the greenback, oil becomes cheaper for domestic consumers.

Meanwhile, oil demand in rich industrial nations has been stagnant. While Europe remains stuck in a recession, an economic recovery in the U.S. has been accompanied by increased domestic oil output and falling oil imports. Even a recent jump in auto sales has not spurred oil consumption, since Americans are merely replacing their older, largest cars with energy-efficient new ones.

The U.S. economic recovery has triggered expectations that the central bank would stop printing dollars and push interest rates higher once more. Currencies such as the Brazilian real and the Indian rupee have weakened as oil prices spiked. Even economic growth in China has been slowing. The International Energy Agency has warned that oil supply is now growing faster than demand, which will increase by just 1.2 percent next year.

For now, oil has become a financial instrument. Oil futures reflect risk perceptions in the Middle East and excess liquidity on Wall Street. Just like the prices of some high-tech stocks on NASDAQ, oil prices may no longer reflect the underlying supply-demand relationship, at least in the near term.

Oil prices are notoriously difficult to forecast, but my scenario calls for a sharp increase into early next year, which will inevitably deal a large blow to an already slowing world economy.

Boring fundamentals such as supply and demand sooner or later catch up with financial instruments. The bigger the bubble becomes, the louder will be its pop once it eventually bursts.

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