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Russia Will Regret Its Gas Deal With China

By Alexei Bayer

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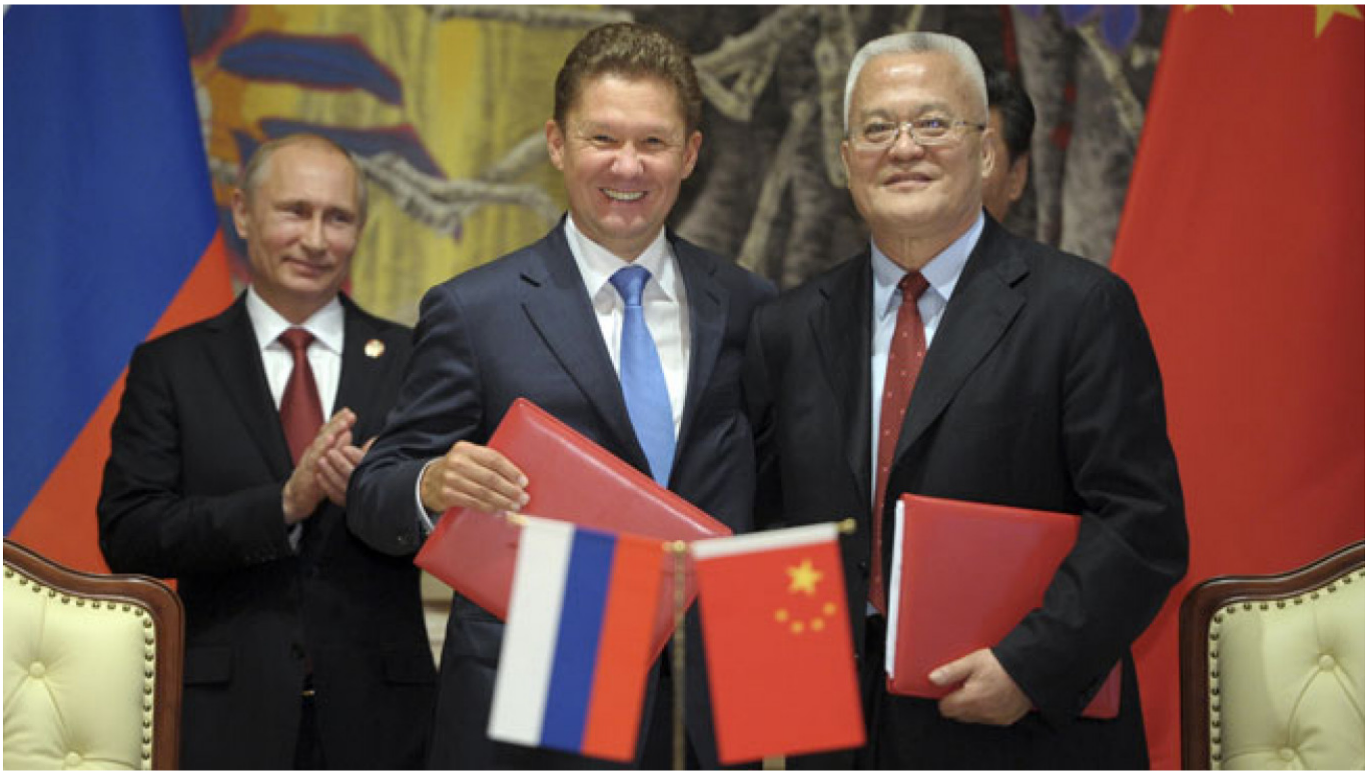

Gazprom CEO Alexei Miller (C) and President of China National Petroleum Corporation (CNPC) and Chairman and President of PetroChina Zhou Jiping (R) shake hands as Russian President Vladimir Putin looks on during a ceremony in Shanghai on May 21.

Much has been written about the natural gas contract which Gazprom, after a brief snag, signed with China National Petroleum Corporation during President Vladimir Putin's visit to Beijing. The official reaction was triumphant: Russia is finding new markets and will no longer be tied to Western Europe with its threat of economic sanctions and plans to reduce dependence on Russian gas. The deal also requires that Russia develop new fields in eastern Siberia, building industrial and transport infrastructure in a remote region.

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Shares of Gazprom rose on the news, continuing their recovery after first dropping sharply following Russia's annexation of Crimea, but the terms of the contract have come under considerable criticism. Economists point out that the price, which remains undisclosed, appears to be very close to the cost of production and transportation. They add that the federal budget will not benefit much as the natural resource tax on the deal has been lifted, that the volumes will not be enough to compensate for the possible loss of the European market and, finally, that it will be a number of years before the gas starts flowing. An extreme view even suggested that Putin had mortgaged Russia's future.

The critics base their analysis on economic considerations and calculations, but Russia no longer takes economics into account when it makes policy decisions. This often happens to commodities exporters and was bound to happen to Russia sooner or later, as it continues to deindustrialize and rely more and more heavily on the production and export of oil and gas. Because Russia had lived under communism for 80 years and its experience with the market economy has been so brief, a shift away from economics has been all the more swift.

The economic history of the world can be summed up in just three words: mind over matter. It is a story of the human mind adding more and more value to matter. For all the talk of the world running out of resources, brains are still far better rewarded than matter of all kinds, whereas matter is valued in economic terms only inasmuch as it supports the economic functions of the mind.

For example, grains collected by primitive hunter-gatherers had low economic value, and there is almost no value-added created by the human mind. Human activities — wheat cultivation, bread-making, retail networks, service, etc. — created ever-growing value, so that actual food becomes no more than a small fraction of the price of a dish on the menu of a fancy restaurant.

Market competition is a sophisticated mechanism to develop innovation. Over the past three decades, business competition intensified dramatically worldwide, leading to higher quality, more choices, lower prices and greater technological sophistication of goods and services.

Not so in natural resources production. Producers of natural resources add little value to the matter which they extract from the earth. If global prices are high, producers prosper, if not, they struggle — the way Russia and other oil producers did in the 1990s. Moreover, the recent historic highs in commodity prices have been a function of extremely high value-added production in the world economy: producers have been earning very high profits which allowed them to pay more for oil, gas, metals and other natural resources.

Not being subject to the laws of economics — at least not directly — countries that rely on the production and export of their natural resources often start neglecting economics. This is especially true of oil producers. The OPEC oil embargo of the early 1970s was a political move to punish the West for its support of Israel in the 1973 Arab-Israeli war, and Venezuela's current oil policies have nothing to do with maximizing its economic utility.

Russia has long been trying to use its "economic weapon," natural gas, to blackmail Ukraine, Belarus and Western Europe, even though it has proven ineffective as well as highly damaging to Russia's own economic interests. Now, it seems, politics have completely supplanted economics in most of Russia's policy-making.

As Europe cuts its dependence on Russian gas, it represents a fresh triumph of mind over matter. Its demand will be increasingly met by liquified natural gas and newly developed fracking technology. At the same time, engineers continue to make strides in energy saving, energy efficiency and alternative energy sources. The same process also structurally undermines long-term prices in the oil market.

Russia used to have a top-notch scientific establishment and industrial base. In the 1990s, it could have joined the global innovation establishment by opening its economy to foreign investment and fostering its own entrepreneurial culture while assigning a supplementary role to its natural resources, i.e., using petrodollars for investment into education, science and infrastructure. But that would have required establishing the rule of law, increasing openness and transparency and getting rid of layers of bureaucracy of all kinds — all of which is anathema to Putin's political system. So Russia became an oil kleptocracy of the worst kind — a dumb oil and gas producer with a huge chip on its shoulder and anger at the rest of the world for not paying it sufficient respect.

By selling its natural gas to China at bargain-basement prices Russia is not mortgaging its future. It is mortgaging the future of Putin's Russia. Because the sooner Russia runs out of oil and gas — or the sooner their prices drop to the 1990s levels — the sooner Russia will get over its current petrodollar inebriation and starts seeking ways to become a prosperous, successful economy living by its brains, not nature's bounty.

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The views expressed in opinion pieces do not necessarily reflect the position of The Moscow Times.