

The New York Times

3 Oil-Rich Countries Face a Reckoning

By SIMON ROMERO, MICHAEL SLACKMAN and CLIFFORD J. LEVY
Published: October 20, 2008

CARACAS, Venezuela — As the price of oil roared to ever higher levels in recent years, the leaders of Venezuela, Iran and Russia muscled their way onto the world stage, using checkbook diplomacy and, on occasion, intimidation.

Now, plummeting oil prices are raising questions about whether the countries can sustain their spending — and their bids to challenge United States hegemony.

For all three nations, oil money was a means to an ideological end.

President Hugo Chávez of Venezuela used it to jump-start a socialist-inspired revolution in his country and to back a cadre of like-minded leaders in Latin America who were intent on eroding once-dominant American influence.

Iran extended its influence across the Middle East, promoted itself as the leader of the Islamic world and used its petrodollars to help defy the West's efforts to block its nuclear program.

Russia, which suffered a humiliating economic collapse in the 1990s after the fall of communism, recaptured some of its former standing in the world. It began rebuilding its military, wrested control of oil and gas pipelines and pushed back against Western encroachment in the former Soviet empire.

But such ambitions are harder to finance when oil is at \$74.25 a barrel, its closing price Monday in New York, than when it is at \$147, its price as recently as three months ago.

That is not to say that any of the countries is facing immediate economic disaster or will abandon long-held political goals. And the price of oil, still double what was considered high just a few years ago, could always shoot back up.

Still, Russia, Iran and Venezuela have all based their spending on oil prices they thought were conservative but are now close to the market level. Significant further drops could tip the three countries into deficit spending or at least force them to choose among priorities. A worldwide recession, which many economists say is likely, would worsen matters, dampening energy demand and holding down prices.

It is not clear whether the new pressures could create opportunities for the United States to ease tensions, or whether the three countries' leaders will rely more on angry words even if they cannot afford provocative actions. Mr. Chávez has continued his overtures to Russia. He, Prime Minister Vladimir V. Putin of Russia and President Mahmoud Ahmadinejad of Iran may now see the United States, hobbled by financial crisis, as even more vulnerable.

Daniel Yergin, chairman of Cambridge Energy Research Associates, a consulting firm in Cambridge, Mass., said oil states were facing something of a reckoning. Originally, he said, they saw the economic crisis as a problem mainly for the United States — but then oil prices went into free fall.

“Now, the producers are experiencing a reverse oil shock,” Mr. Yergin said. “As revenue went up, government spending went up and expectations of a continuing windfall led to greater and greater ambitions. Now they are finding how integrated they are into this globalized world.”

Venezuela

Mr. Chávez was emphatic last month when he announced that Venezuela would engage in naval exercises with the Russian Navy in the Caribbean. “Go ahead and squeal, Yanquis,” he said. “Russia’s naval fleet is welcome here.”

The moment, made possible in part by a flood of petrodollars used to buy Russian weaponry, must have been sweet for a man who has spent his presidency wagging his finger at the United States and railing against its capitalist model. Cozying up to Russia, whose leaders have been increasingly at odds with the United States, evoked cold war rivalries in the hemisphere.

Mr. Chávez has also used his oil money — in direct payments and through subsidized oil shipments — to win friends in the hemisphere and elsewhere, including President Evo Morales of Bolivia, who expelled the United States ambassador in La Paz last month, saying the envoy was involved in plotting a coup.

Domestic spending in Venezuela has also surged, through the creation of a wide array of social welfare programs that furthered Mr. Chávez's goal of building a socialist-inspired state — and suppressed opposition. The 2009 budget, based on \$60-a-barrel oil, includes a 23 percent increase in government spending, to \$78.9 billion.

At \$140 a barrel for oil, that was conservative. With prices now uncomfortably close to \$60 a barrel, economists in Venezuela are expressing alarm over the government's ability to pay its bills, including those for arms purchases.

Venezuelans are already struggling with an inflation rate of 36 percent, one of the highest in the world.

Mr. Chávez said on Saturday that the country could endure any oil price decline, citing its \$40 billion in foreign currency reserves, though he then qualified his remarks by saying that oil prices at \$80 to \$90 a barrel would be sufficient for his plans.

Still, fears of an impending economic crisis in Venezuela are increasing because of a lack of transparency in public finances and because the economy has grown far more dependent on oil in the decade Mr. Chávez has been in power, with seizures of rural estates weakening agricultural output and nationalizations scaring away foreign investors.

“This country will be paralyzed because it is so dependent on petroleum,” said Oscar García Mendoza, president of Banco Venezolano de Credito, a private bank.

Anxiety over the economy already helped lead to a sell-off of Venezuelan government bonds, sharply limiting the country's borrowing options.

Last week, Venezuela's embassy in Nicaragua said the Caracas government would postpone construction of a \$4 billion oil refinery there. And the national oil company announced that it would tighten the terms for subsidizing oil exports to some Caribbean countries.

"We're in the same situation of people who have lost a limb but can still feel it," said Ricardo Hausmann, a Venezuelan economist who teaches at Harvard. "I don't know how long it will take for Chávez to realize he's lost a limb."

Iran

When President Ahmadinejad presented his budget to Parliament in 2007, the United Nations Security Council had already imposed economic sanctions on Iran because of its nuclear program. The president said it did not matter.

"Even if they issue 10 more such resolutions," he said, "it will not affect Iran's economy and politics."

He was partly right. It hardly affected Iran's politics. There was another resolution two months later, and another a year later — and still, Iran augmented its nuclear program, even as its economy was squeezed.

One of the main reasons it was able to endure the economic punishment was the price of oil. Iran has the second largest known oil reserves in the world, and it has used them in the past four years as a political and economic weapon to defy and undermine the West while promoting its own agenda.

Oil money helped Iran spread its influence in Iraq. Oil money helped it challenge Arab political dominance in the Middle East. Oil money helped spread its influence in Lebanon, through Hezbollah, and in the Israeli-Palestinian conflict, through Hamas.

At home, oil money allowed Iran's ideological hard-liners to preserve their monopoly on power, to buy political allegiances and to offset the fiscal damage of their economic policies. All that may now have to be recalibrated.

"The drop in oil prices will make the Iranian regime re-examine its calculations because its political immunity is less," said Mustafa El-Labbad, director of the

East Center for Regional and Strategic Studies, an independent research center in Cairo. “Their regional presence and role will shrink.”

Even before the global economic crisis undercut the price of oil, Iran was gripped by an economic crisis. Now, inflation is running at 30 percent, according to the Central Bank. And this month, bazaar merchants, who wield significant political power, went on strike after the government imposed a value-added tax.

Mr. Ahmadinejad’s way of dealing with the general economic distress has been to increase government spending, primarily through imports. But the International Monetary Fund said in August that Iran would face unsustainable deficits should prices for its oil fall to \$75 a barrel.

It is not expected that economics will force Iran to change its underlying ideology or long-term goals. Still, if prices stay depressed for long, it could mean a greater willingness in Tehran to find a compromise on the nuclear issue and, perhaps, a political shift that left Mr. Ahmadinejad vulnerable in June’s presidential election, analysts said.

“The government has distributed money and has encouraged spending,” said Saeed Leylaz, an economist and political analyst in Tehran. “It has given high salaries to its own supporters. They have increased their expectations, and there is no way they can give them less now without making them unhappy. If the government fails to respond to their expectations, it might lead to a crisis.”

Russia

On a winter day in 2006, Russia suddenly cut off the supply of natural gas to Ukraine, where a pro-Western government had come to power. The Kremlin cited a dispute over prices. But some Western officials said Vladimir V. Putin, Russia’s president at the time and still its paramount leader, was sending a message: Russia was willing to use its vast energy reserves to try to reassert the dominance it lost with the Soviet Union’s collapse.

Two months ago, the muted reaction of some European nations to Russia's invasion of Georgia seemed to indicate that Mr. Putin's policy was working, some foreign policy analysts said. Europe had become dependent on Russia's gas and could not afford to mount a strong challenge, they said.

Now, however, with gas prices tumbling, this strategy has been thrown into question. Europeans may no longer be as intimidated, knowing that Russia is less able to pressure its customers.

"The more other countries are nervous about their energy security, the better Russia is geopolitically," said Peter Halloran, chief executive of Pharos Financial Group, an investment fund based in Moscow.

Still, at least in terms of its domestic economy, Mr. Halloran and other experts said Russia was better positioned to weather lower prices than were many other oil and gas producers, because it had adopted conservative fiscal practices in recent years.

The country deposited a significant portion of its oil revenues into two stabilization funds, which totaled \$190 billion at the beginning of this month. The Russian budget is pegged to an oil price of roughly \$70 a barrel — most revenues exceeding that have gone to these so-called rainy-day funds.

The Kremlin also succeeded in recent years in establishing control over many of the pipelines that transport oil and gas in the region — an achievement that will endure despite the lower prices.

The Kremlin has started tapping into its stabilization funds to prop up the banking industry and the stock market, which has been hard hit by the international financial crisis, dropping by more than two-thirds since May. The government may also rescue many of Russia's oligarchs, the industrial magnates who were thriving with the high price of natural resources but have now been suffering steep losses.

These bailouts, combined with declining oil and gas revenues, could make it difficult for the Kremlin to carry out plans to modernize the country's aging infrastructure, from highways to schools, and still promote Russian ambitions abroad.

Even so, opposition politicians in Russia said they did not perceive sagging prices as undermining Mr. Putin's power.

"I think that it's too early," said Grigory A. Yavlinsky, an opposition leader. "The crisis at the moment is not related to the population enough. The banks are still open, and unemployment is not yet going higher. It's a threat, but it's only a potential threat."

Simon Romero reported from Caracas; Michael Slackman from Amman, Jordan; and Clifford J. Levy from Moscow. María Eugenia Díaz contributed reporting from Caracas, and Nazila Fathi from Tehran.
