Higher oil prices alone won't rescue failing petro-states like Venezuela

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Vast oil reserves have not stopped riots and food shortages in Venezuela (Source: Getty)

At the annual International Petroleum Week at Grosvenor House on Park Lane last week, all eyes were on Mohammed bin Saleh al-Sada, the Qatari energy minister. The dignitary was honoured with a special award, "International Oil Diplomacy Man of the Year 2016", as one of the masterminds behind the production cuts agreed to last November in Vienna.

Despite that, the Qatari minister's tone this year was more that of caution than celebration. The minister's concerns are understandable. Distribution of oil rents in petro-states is politicians' raison d'être, because they believe that achieving higher and less volatile prices brings prosperity and stability to their constituencies.

While the laborious efforts at Vienna have brought some relief to the oil industry, they don't solve the systemic problems facing petro-states. Addressing them will require a change of paradigm – something we are just starting to see, albeit on a limited scale.

At first glance, the award to the minister is justified. Not many believed that an agreement between Opec and non-Opec countries to cut production could actually be reached. When the usual suspects of the oil industry gathered on Park Lane last year, the mood was much gloomier: the price of a barrel had dropped to a 13 year low of $27. Today it fluctuates around $55 – that's a material improvement for the sector.

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Unfortunately, the reality is less straightforward. Take the case of Venezuela (one of the main cheerleaders for the cuts). It went from being one of the most well-off countries in Latin America and worldwide in the 1950s to a state of almost complete economic collapse, currently facing rationing and food riots.

Disintegration in Venezuela started long before the oil price crisis. Strikingly, in 2013, during the record high crude price, the real inflation-adjusted GDP per capita in Venezuela was lower than during the second half of the 1970s. Moreover, not many people realise that Venezuela – not Saudi Arabia or Russia – possesses the largest reserves of crude in the world. And such is the decline of the Venezuelan petroleum company PDVSA that its overall oil production is actually lower today than it was half a century ago.

In oil economies a pricier barrel is not synonymous with economic well-being – neither is it a guarantee of political stability. Mass civil protests had taken place in Iran, Russia, Venezuela and other petro-states before the price collapsed in 2014. And let's not forget that the Arab Spring swept through the Middle East and Northern Africa when the oil price was at its zenith.

In many countries, the state-dominated model of "resource nationalism" has failed to fulfil expectations. Instead, it has created a fertile ground for rent-seeking and corruption. This is the main reason behind the rise of discontent in a number of oil-exporting economies: from the democratic change of government in Nigeria to the impeachment of Dilma Rousseff in Brazil.

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Some governments have sensed the trend. They are taking limited steps to make the oil rent redistribution more transparent. Deputy Crown Prince Mohammed bin Salman's announcement last year that Saudi Arabia will privatise a share in the oil giant Saudi Aramco through an initial public offering is a first step in that direction. The 31 year old Prince Mohammed heads the Economic Council and is the informal leader of the modernisers in the royal house of al-Saud. In an interview with the Economist he argued in favour of an economic "revolution in the spirit of Thatcher."

Yet the real issue facing governments in Saudi Arabia, other Opec countries, and Russia is not the price of crude, but rather the corruption of the underlying institutional system (which actually does not subside but rather accelerates under higher oil prices). It is the quality of institutions that, essentially, shapes the final result in oil economies: prosperity and innovation or stagnation and eventual decline. Institutions determine whether oil is a blessing or a curse.

As demonstrated by countries like Australia, Canada and Norway, a strong institutional framework – namely, economic freedom, secure property rights, and transparent and fair regulation – can keep oil exporting states afloat during commodity market turbulence. Sound institutions can also help to diversify the economy when investments in oil and gas generate smaller returns.

Building such institutions in petro-states is a laborious task – it infringes on some powerful interest groups whose incomes depend on rent-seeking. Overcoming their resistance and eradicating corrupt practices is much less glamorous than playing high level cartel games or meeting in glitzy hotels in London. But when it comes to building economic resilience and lasting prosperity, there seems to be no real alternative to modernisation.

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