# Did *Yellen* Break OPEC?

**BY PHILIP K. VERLEGER, JR.**

*For the first time in fifty years, a sharp rise in oil prices did not produce a recession.*

In January 1979, I recall being called to the office of Anthony Solomon, then U.S. under secretary of the Treasury for monetary affairs. An oil worker strike in Iran had collapsed the country's production and prompted the Shah to flee. The United States called on Saudi Arabia to boost oil output to offset the lost Iranian crude. The Saudis agreed but insisted on a higher price. At the time, I was an adviser on oil and energy policy at Treasury.

Secretary Solomon had one simple question: "How could they do this to me?" Tony took the price increase as a personal affront. History shows, though, that the market was disintegrating.

Solomon's disappointment followed the failed efforts of key Treasury officials, including William Simon, to negotiate lower oil prices with Saudi Arabia. (While Simon and his successor Mike Blumenthal did not talk the Saudis into lower prices, they did get oil-exporting nations to deposit their increased revenue with Western banks, an important achievement.) Indeed, from 1980 to 2022, all efforts by Treasury officials to influence oil prices bombed.

Current U.S. Treasury Secretary Janet Yellen has ended Treasury's dismal track record. She has done it by applying good economic policies to the problem of high oil prices while ignoring all oil-exporting countries, including Saudi Arabia. Oil prices today are probably 30 or 40 percent lower than they might have been had past policies been continued. And, for the first time in fifty years, a sharp increase in oil prices has not been associated with a recession. Yellen deserves credit for this success.

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## Yellen's Success Summarized

*U.S. Treasury Secretary* **Janet Yellen.**

■ U.S. policy toward oil following the Ukraine invasion has been directed toward breaking the market power enjoyed by oil-exporting nations, including OPEC members and the countries working with the cartel.

■ Through strategic reserve releases and sanctions, the policy has succeeded. The essential component of the success has been the United States' ability to establish the world's two largest crude oil buyers, China and India, as the sole buyers of Russian crude. These buyers are aggressive purchasers that can squeeze Russia, which has few alternatives, and force larger and larger discounts.

■ The squeeze will intensify as term contracts with Middle Eastern suppliers expire. The oligopsonists, India and China, will drive crude prices down.

*—P. Verleger*

*Yellen's greatest success will be associated with the cap or price ceiling on Russian crude oil that she convinced G7 nations to adopt.*

Yellen's achievement can be seen in Figure 1. This graph shows the year-over-year change in gasoline prices by month from 1973 to 2023. The shaded areas denote recessions as defined by the National Bureau of Economic Research. Note that the recessions of 1973–74, 1980, 1990, 2000, and 2008 were all associated with substantial gasoline price increases. One can also note that no recession has been associated with the 2021–2022 price rise even though it is the largest and longest among these examples.

The United States and the world avoided recession this time in part because Yellen spearheaded the large strategic reserve oil release announced in March 2022, which totaled more than two hundred million barrels over the twelve months. The release was widely derided by the "sophisticated" pundits who comment almost daily on oil markets. However, it worked.

The release worked because it defused the "hoarding" response that accompanied earlier disruptions. The 1990 price increase after Iraq's invasion of Kuwait led to large price increases despite inventories being high. Many pundits were puzzled by the price rise. In contrast, anyone who had studied commodity markets understood that firms that held inventories chose to limit their selling, fearing the stocks could not be replaced. What became known as a "fear premium" spread throughout the oil industry. A recession followed.

Yellen and Biden administration economists understood the risks and moved quickly to boost supplies to prevent buyers from aggressively bidding prices higher to assure they had adequate supplies. The strategic stock release quickly defused the 2022 crude price rise in which oil had shot up as much as 75 percent in the first days after Russia invaded Ukraine.

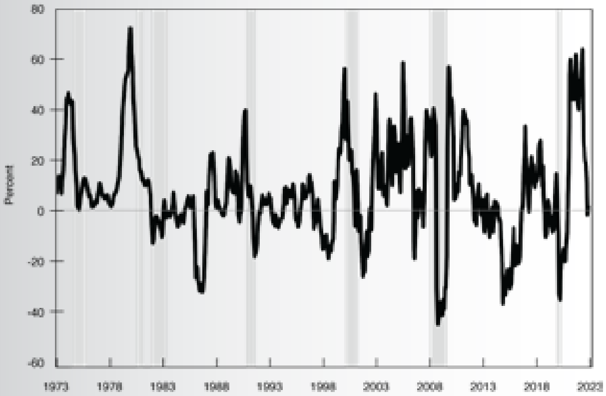
I calculate that, over twelve months, the strategic crude oil release by the United States and other International Energy Agency nations depressed prices by $25 per barrel, which likely allowed the United States and possibly Europe to avoid a recession. Yellen's fifty years of experience in observing the macro effects of energy market disruptions while at the Federal Reserve Bank of San Francisco, the U.S. Federal Reserve, and now Treasury no doubt guided her actions.

Yellen's greatest success, though, will be associated with the cap or price ceiling on Russian crude oil that she convinced G7 nations to adopt. With it, Yellen has cleverly created an oligopsony for Russia's oil. Neither of the two remaining major buyers—India and China—is a passive price taker. Indeed, both are well-known for negotiating tough bargains with suppliers. These countries will force Russian oil firms to grant larger and larger discounts.

The cap was officially proposed at the June 2022 G7 summit in Germany. Yellen had previously introduced the concept to her EU counterparts in May. As the *Financial Times* reported, the aim was to limit Moscow's energy revenues.

According to the U.S. Treasury's proposal, the cap would be enforced by denying insurance protection to ships carrying Russian oil if their cargo's bill of lading price exceeded the price threshold. This would prevent Russian oil

**Figure 1 Percentage change in gasoline CPI from the same month one year earlier, 1973 to 2023**




Note: Shaded areas indicate periods of recession.
Sources: U.S. Bureau of Labor Statistics, NBER, PKVerleger LLC.

from moving on the high seas unless it was priced below the stipulated level. As the *Wall Street Journal* explained, "The crux of the plan: leveraging Europe's dominant position in insuring, financing, and shipping oil to shape how Russia sells crude around the world." Insurance companies are banned from providing these services unless the oil is sold below $60 a barrel. Yellen's goal was to keep the Russian supplies on global markets while restricting the country's income.

The initial response to the price cap was great skepticism. I argued that Russia could evade the ceiling by requiring buyers to contract with the Russian central bank for "entitlements" to buy its oil. An Indian buyer, for example, might purchase one million entitlements for $20 per barrel. It would then exercise the entitlements, paying $20 less than the world oil price and complying with the cap.

Russia apparently thought it need not take such complicated steps. Putin may have gambled on this because he believed, as many others did, that the price cap would boost prices. For example, a JPMorgan report predicted that prices might exceed $300 per barrel if Russia chose not to cooperate and instead cut oil production.

By most measures, the price cap has succeeded. According to Argus Media, Urals crude is selling for a discount of almost $35 per barrel to Brent. Before the cap, the discount was around $3.

Still, some have challenged the price cap's success. On February 24, Bloomberg published an article that began, "Russian companies got far more money from selling the country's oil than previously thought in the weeks that followed the imposition of a price cap on the nation's exports, a group of academics said."

The report indicated that the academics found that Russia's crude price averaged $74 per barrel in the four weeks after the cap went into effect. The analysis was based on customs-level import data for crude sales to buyers around the world. Table 1 shows the average export prices reported in the study for the period December 5–December 31, 2022.

The study cited by Bloomberg was conducted by economists from Columbia University, the Institute of International Finance, University of California, Los Angeles, and IE University. The authors (Babina *et al.*) detailed the successes and failures of efforts to cap Russian income. While they concluded that the sanctions imposed at the start of the war have cut Russian income by $3 billion per month, the data they presented make a strong case for the $60-per-barrel price cap not working as well as it should, and the authors offer recommendations for tightening the sanctions.

What Babina *et al.* failed to recognize is that the combined impact of the sanctions on Russia, the strategic stock release, and the price cap has lowered the world's overall price of crude. Countries like India have been the primary beneficiaries of this impact.

India has engaged in an undeclared economic war with Saudi Arabia since March 2021. At that time, India's oil minister complained about the Saudis' efforts to boost oil prices led by oil minister Prince Abdulaziz bin Salman: "While we do not favor too low prices, we also do not support high prices, which deny energy access to millions in India," he warned. The Saudi minister responded that India should use the oil purchased for its strategic reserve at lower prices.

Given the availability of cheap Russian oil, India has responded since its "spat" with the Saudis by cutting imports from Middle Eastern countries, which had averaged more than 80 percent of total imports previously. Argus

*India has engaged in an undeclared economic war with Saudi Arabia.*

Media noted at the end of January 2023 that India was "on course" to reduce its imports from the Middle East to less than 50 percent of the total for the first time "in years." The report stated that India's imports in January would fall to 48 percent, and the difference would be made up by imports from Russia, which were slated to rise by 50 percent.

The Argus Media article attributed the shift to Russian oil to the large discounts obtained by Indian buyers. This commentary suggests the price cap is working. Columbia University researchers Robin Mills and Ahmed Mehdi also noted that the shift in buying has put pressure on spot Middle East prices: "Growing volumes of Russian Urals to Asia and other non-European markets have also put pressure on the valuations of Middle Eastern spot crudes."

The Argus editors put the drop in Middle Eastern crude prices at $2.10 per barrel. This cut is directly attributable to Yellen's price cap and U.S. sanctions. This discount will grow in time if the cap remains in place. Currently, many buyers in India and China are contractually obligated to purchase oil from Saudi Arabia and other Middle Eastern nations. These buyers will demand greater flexibility from oil sellers as these contracts expire, especially if Russia continues to push its crude into the market.

Such discounts highlight Yellen's success in reducing global oil prices by getting the price cap established and securing the strategic stock release. Her efforts can be summarized as follows:

■ U.S. policy toward oil following the Ukraine invasion has been directed toward breaking the market power enjoyed by oil-exporting nations, including OPEC members and the countries working with the cartel.

■ Through strategic reserve releases and sanctions, the policy has succeeded. The essential component of the success has been the United States' ability to establish the world's two largest crude oil buyers, China and India, as the sole buyers of Russian crude. These buyers are aggressive purchasers that can squeeze Russia, which has few alternatives, and force larger and larger discounts.

**Table 1 Average Price of Russian Crude Oil Exports, December 5 to 31, 2022**
(Dollars per barrel)

| | Price |
|---|---|
| **Baltic Sea ports** | 59.86 |
| **Black Sea ports** | 63.34 |
| **Pacific Ocean ports** | 82.24 |
| **Arctic Ocean ports** | 79.31 |
| **Druzhba pipeline** | 62.98 |
| **China via pipeline** | 80.91 |
| **Destination reported** | 74.49 |

Source: Tania Babina et al., "Assessing the Impact of International Sanctions on Russian Oil Exports," SSRN, February 22, 2023.

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Yellen's success has been aided by another important characteristic of the oil market: the independence of refiners from crude producers. Fifty years ago, integrated companies such as Exxon processed 60 percent of the oil refined globally. Oil was monetized in that era only when the products went into consumer fuel tanks. Today, most oil is processed by independent refiners who pay cash for the crude. These firms understand that oil exporters need to sell crude. They are also aware that the U.S. government today and other governments will sell from strategic reserves in the event of a disruption. Consequently, refiners are limiting their crude purchases and putting pressure on crude prices.

Refiners in Europe and the United States will also likely cut the oil volumes they process because they fear an increase in imports from traders and refiners in India and China who have access to lower-priced crudes. The companies with such access have every incentive to maximize product output, dumping the excess on other markets. The availability of low-priced Russian products to these nations resulting from EU and U.S. bans could increase the impact. India, for example, should logically boost its imports of discounted Russian diesel while increasing exports of diesel produced at Indian facilities from discounted Russian crude. This would put further downward pressure on crude prices.

The unappreciated development over the last year, then, is that Janet Yellen, the U.S. Treasury Secretary, has essentially broken OPEC. From her point of view and the position of the U.S. administration, the best thing about this development is that no one has noticed. Yellen has slain—or at least temporally immobilized—the OPEC dragon. ◆