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OPEC's Quota Conundrum:
Production Quota Hype (Shouldn't) Move Prices

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Oil prices have rallied of late, fueled by speculation over a potential production quota among major producers.[1] Signaling by key actors suggests renewed interests to stabilize production and reduce current global supply. Khalid al-Falih, Saudi Arabia's Energy Minister, indicated his country would be willing to take up the matter of market stabilizing at an informal meeting to be scheduled in September.[2] Russia's oil minister revealed that they are in ongoing consultations with Organization of the Petroleum Exporting Countries (OPEC) members about the market and the possibility of a joint production cap, "if necessary."[3] Even Iran has expressed interest in stabilizing the market.

Oil remains a double-edged sword in the Emerging Market (EM) space. Falling oil prices typically indicate weaker commodities prices and hurts several EM economies including Russia, Nigeria, and Brazil. Overall, though, with most EM countries being net oil importers, they are experiencing improving current account balances attributable to lower energy prices. Despite a historically positive correlation between oil prices and EM markets, EM bonds and equities so far are holding on to recent gains.[4] As a result, actions by OPEC and other major exporters to reduce supply would have significant consequences, both positive and negative, for EM markets. So what is the chance of either a production cut or freeze? While cautious about historical examples, they evidence the difficulties in aligning and maintaining the various parties' interests. Even within OPEC, historical data shows the cartel's weakness in observing production limits.

Competing Producer Interests

For Saudi Arabia, its primary concern is maintaining market share rather than focusing on falling prices.[5] This is not to say that they are immune or indifferent to the recent decline in prices. Saudi Arabia is currently running a significant, and what many deem an unsustainable, fiscal deficit. In light of declining state revenues, the Saudi government has undertaken several domestic policies, including the cutting of its generous fuel subsidies and the issuing of new government debt. However, they appear much more willing and able than most exporters to suffer short-term pain for long-term positioning.

Meanwhile, Russia's situation is akin to many oil exporters. On the one hand, lower prices are causing severe budgetary pains. The Russian government remains heavily dependent on the revenues from oil exports which fund more than 40 percent of the national budget. The need for stabilizing prices is a concern given that the government ran a budget deficit of 2.6 percent in 2015, the highest in five years. On the other hand, it also is concerned with market share. Despite falling prices, Russian production has surpassed Soviet-era highs given its dependence on oil revenues, high or low. Additionally, Russia-OPEC relations have a rocky history with disputes in 2001 and 2008 triggering price wars.

By far the most critical player for any successful cut or freeze is Iran. Recently freed from international sanctions, Iran seeks to recapture its pre-sanctions market share hoping to ramp-up production to 2012 levels of approximately 2.3 million barrels of oil per day, placing its output as only behind Saudi Arabia's. Although refusing to participate in the Doha talks in April, Iranian official have warmed to the possibility of a market stabilization plan, but continues to assert its sovereign right to obtain its pre-sanctions market position.

Important to note is that the contemplated agreement is for a production freeze, not cut. Given the record levels of production by Saudi Arabia and Russia, as well as other non-OPEC countries, simply freezing production is unlikely to do much market stabilization. Moreover, a mere freeze is unlikely to satisfy members, like Algeria and Venezuela, who are intensely focused on raising market prices given current domestic economic conditions. Oversupply remains the real culprit, compounded by the International Energy Agency's forecast of declining global demand.[6]

OPEC's Prisoners' Dilemma

Any possibility of a production quota warrants a healthy dose of skepticism. Given the divergent interests of the indispensable countries, there is little reason to be optimistic about the successful implementation let alone longevity of the agreement's terms. Participant defection has been the norm as to such OPEC/Non-OPEC efforts in the past. The similar OPEC/Non-OPEC agreements reached in 1999 and 2001 suggest any deal would be short-lived as those deals quickly collapsed as participants breached production terms in relatively short order. Notably, a 2001 agreement fell apart due to Russia's backslide.

Moreover, dealings within OPEC have historically suffered from a high degree of defection by member countries. Rather than controlling production as would be expected by a cartel, a recent study points out the endemic nature of cheating by member states. Data collected by Dr. Jeff Colgan of Princeton University reveals that during 1982 to 2009 OPEC members overproduced the cartel's established quota 96% of the time with all but two members overproducing more than 80% during the period.[7] For its part, Saudi Arabia exceeded production quotas 82% of the time.[8] Putting the extent of this overproduction into context, it averaged 1.8 million barrels of oil per day, equaling Libya's 2009 total daily output.[9] Hence, if history is any guide, we should not expect anything close to compliance with any possible brokered quota deal.

[1] Johnson, Christopher. "Oil Steady near Six-week Highs on Talk of Supply Freeze." Reuters. August 18, 2016. Accessed August 18, 2016. http://www.reuters.com/article/us-global-oil-idUSKCN10T04A?il=0.
[2]Saefong, Myra P. "Russia Sparks Oil Rally, but Saudis Still Hold the Cards." MarketWatch. August 16, 2016. Accessed August 17, 2016. http://www.marketwatch.com/story/russia-sparks-oil-rally-but-saudis-still-hold-the-cards-2016-08-15.
[3] "Russia Says Oil Market Talks with Saudi Developing - Newspaper." Reuters UK. August 15, 2016. Accessed August 17, 2016. http://uk.reuters.com/article/uk-oil-opec-russia-saudi-idUKKCN10Q0NM.
[4]Langner, Christopher. "Emerging Markets' Treacherous Oil Slick." Bloomberg.com. August 1, 2016. Accessed August 17, 2016. https://www.bloomberg.com/gadfly/articles/2016-08-02/oil-s-tumble-is-a-slippery-slope-for-emerging-markets.
[5] Raval, Anjli. "Saudi Oil Production Rises to Record Level in July." Financial Times. August 10, 2016. Accessed August 17, 2016. https://www.ft.com/content/42a0811c-5ee3-11e6-a72a-bd4bf1198c63.
[6] "Oil Market Report." August 11, 2016. Accessed August 26, 2016. https://www.iea.org/oilmarketreport/omrpublic/.
[7] Colgan, Jeff (2014) “The Emperor Has No Clothes: The Limits of OPEC in the Global Oil Market,” *International Organization*, 68, 3:pp 599-632.
[8] Ibid.
[9] Ibid.