Oil Price Stability Expected Despite the Iranian Crisis: Iran Striving for Depoliticized OPEC

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The international standoff over Iran's nuclear program has entered its most volatile phase to date. In light of the deteriorating security situation evidenced by an escalating series of sanctions, assassination attempts, and growing talk of a preemptive military strike against Tehran's nuclear facilities, the region is facing one of its most dangerous periods ever. Not surprisingly, this crisis continues to affect crude oil prices. After Iran announced that it would cut off oil supplies to Britain and France in mid-February, the price of crude spiked to over $120 a barrel, the highest it has been since April last year.

However, international oil prices are likely to stabilize in the long-term owing to the cooperation-inducing systems within the Organization of Petroleum Exporting Countries (OPEC). Despite the conflict between "price doves" and "price hawks," and the rivalry between Saudi Arabia and Iran, the common fears of an early exhaustion of reserves and falling prices have incentivized OPEC's rational oil oligopolies to keep production quotas, maintain prices, and cooperate with each other. Moreover, the cooperative mechanisms of the cartel often favor poorer price hawks and let them produce oil at the expense of wealthier price doves, especially Saudi Arabia. The long 'shadow of the future,' in which the long-term benefits of ensuring OPEC's unity ultimately outweigh short-term costs, makes this cooperation possible. Accordingly, price hawk Iran, in turn, has been averse to the risk of supply disruption and followed the rule of consensus at critical moments since OPEC's quota system also secures the country's revenues and the regime's survival.

Indeed, the record suggests that, more often than not, the member countries of OPEC have consistently sought to ensure price stability. The 'shadow of the future' will continue to hold true. More specifically, Iran under the combined pressures of sanctions and threats of military strike will not try to politicize OPEC – regardless of who wins the March parliamentary elections. Saudi Arabia, on the other hand, will adjust its production levels or pick up the deficit in order to compensate for Iran's situation and maintain stable oil prices and supplies. In this respect, the political logic of sanctions does not seem to hurt the economic interests of the cartel. The continued existence of these dynamics within OPEC suggests that long-term global oil prices are expected to remain stable even if Israel launches strikes on Iran.

The Iranian Nuclear Crisis and Oil Price Instability

In order to deter Iran's uranium enrichment program and its alleged pursuit of nuclear weapons, the United States has intermittently shifted between diplomatic negotiations and economic sanctions. In light of these developments, President Obama's signing of Section 1245 of the National Defense Authorization Act for Fiscal Year 2012 (NDAA) on December 31st, 2011 marked a significant turning point in U.S. policy towards Iran. With the goal of attempting to 'reduce Iranian oil revenues and discourage transactions with the Central Bank of Iran (CBI) by providing for sanctions on foreign financial institutions that conduct certain transactions with the CBI,' the NDAA seeks to stop a major source of funding that has been used for the Iranian nuclear program.

Yet the United States' sanctions against Iran have raised concerns about the effects that these sanctions are likely to have on global oil prices and supplies. In particular, the onus that President Obama's latest sanctions have placed on major oil consumers to adopt alternative oil suppliers has heightened uncertainty in an already fragile global economy. In fact, the fluctuations in world oil prices in recent months have underscored the disruptive consequences of the new sanctions. Furthermore, oil price hikes after each new development, from Iran's threat to block the Strait of Hormuz to its declaration that it would preemptively stop oil exports to Britain and France, are seen as evidence of the inability of the international community to ensure a consistent and stable supply of crude oil to global markets.

OPEC: Divided and Ineffective?

Receiving much of the criticism for rising oil prices has been OPEC. Given that it produces more than a third of the world's oil and possesses more than three quarters of the world's known reserves, OPEC has enormous leverage in terms of being able to set production quotas that shape the world economy. The apparent inability of OPEC to quickly adjust crude oil production in response to major disruptions in global oil supply is frequently viewed as an indicator of how it will behave in response to the new Iran sanctions and the inevitable changes in oil supplies.

OPEC is the world's second international oil regime after the "Seven Sisters." At its height in the 1960s, the Seven Sisters – a cartel of the world's major private oil companies including what are today BP, Shell, Chevron, and ExxonMobil – controlled the vast majority of global oil supplies. Yet the discovery of new oil fields in Libya, Qatar and the United Arab Emirates (UAE) during the late 1960s, followed by the nationalization of the most productive oil fields, precipitated the rise of independent state producers. Consequently, given their combined production output, the Middle Eastern members in particular have played a central role within OPEC. Represented by the oil ministers of the 12 member countries, OPEC is the outcome of the first collective reaction by nation states toward the first international oil regime that had been dominated by private companies. Hence, the Seven Sisters, as an organized cartel, no longer has access to many key fields in the region, instead relying on individual long-term contracts with host countries, at best. Not surprisingly, this rise of state-controlled oil production seemed to mark the end of effective controls over stable prices.

Moreover, OPEC countries have taken different paths of development and institutionalization, and their attitudes towards the use of oil have varied significantly. In doing so, OPEC members are split between moderates and radicals. The contentions between what are commonly referred to as "price doves" and "price hawks" have ramifications for how OPEC sets output quotas for member countries and how this ultimately affects global oil prices. As a matter of fact, this division is between the two largest producers, Saudi Arabia and Iran.

Price doves such as Saudi Arabia and the Gulf Cooperation Council (GCC) countries such as Kuwait, Qatar, and UAE are generally wealthier on per capita income basis, possess significant oil reserves, and have smaller populations relative to their oil exports. Therefore, they seek to ensure sustainable demand via a slow production process at moderate prices. On the other hand, price hawks such as Iran, Algeria, and Venezuela possess lower per capita incomes, lower oil exports per capita, and larger populations and thus prefer quick profits via lower production at higher prices. Furthermore, the price hawk members have often addressed the possibility of converting their petrodollar reserves to Euros in order to bypass international trade restrictions. Accordingly, this internal division has been also interpreted as evidence of the cartel’s limited ability to regulate oil prices and production.

OPEC as the Ultimate Price Stabilizer

While many of these criticisms regarding the ineffectiveness of OPEC are legitimate, there is a considerable capacity that OPEC possesses in ensuring stable oil prices that is often overlooked. OPEC's operation as a cartel - that is, by setting prices so as to maximize and distribute profits among its members - has forced its members to pursue strategies that prioritize consensus and unanimity in order to preserve the organization. Except for the 1973 and 1980 oil crises that were triggered by the Arab-Israel conflict and the Iranian Revolution, where most Middle Eastern members were deeply involved, OPEC has largely determined prices via cooperative arrangements and operated as an effective cartel in stabilizing the global oil market. For instance, despite the recent political turmoil caused by the Iraq war and the Libyan civil war, as well as supply disruptions in Nigeria, OPEC has successfully adjusted production to accommodate stable supplies.

As a matter of fact, last December, OPEC members reached a consensus to increase quotas to a group production ceiling of 30 million barrels per day at its regular semi-annual meeting. The deal vindicated Saudi Arabia’s position after its proposal to raise output was rejected by

Iran, Algeria, and Venezuela last June. Most importantly, Iran's oil minister announced that he had received private assurances from Saudi Arabia that it would not steal Iran's share and fill any gap in the oil market left by Western sanctions against Iran. Similarly, when the United States had imposed sanctions against Iran under the Iran-Libya Sanction Act (ILSA) since the mid-1990s, Saudi Arabia decided to allow Iran to produce slightly more oil than other members in 1999. Also, as oil production in post-civil war Libya has recently ramped up, Saudi Arabia and other price doves cut their production to make space for Libya.

Cooperation in the Long 'Shadow of the Future'

This pattern of cooperation is essentially derived from two important factors; dual dangers of an early exhaustion of crude oil reserves and falling prices for oil exports. Behaving as rational oil oligopolies, OPEC members have continually tried to ensure that these two challenges do not negatively impact their overall oil revenues. Although Saudi Arabia and other price doves frequently face resistance in setting OPEC quotas from Iran and other price hawks, both groups know that cutting production to increase prices can drive consumers toward alternative energy supplies or seek greater fuel efficiency. At the same time, raising output to cut prices often leads to a 'bubbling economy' where easy money and inflated asset prices are widespread, and manufacturing activities slow down, thus resulting in less energy consumption. In order to secure their long-term interests and to keep prices under control, the cartel members try to maintain a united front. In doing so, the cartel can achieve the common goal of increasing their revenues by resolving the prisoner's dilemma inherent in an institution such as OPEC that lacks binding commitments or enforcement mechanisms.

The cooperative mechanisms of the cartel often allow poorer, more unstable price hawks to have larger quotas at the expense of richer price doves who can afford to calculate better future payoffs. Saudi Arabia, given its unique position as the only "swing" producer capable of adjusting its supply output to influence global oil prices, has sought to mitigate any dramatic changes to the status-quo. For price doves in particular, the long-term rewards of cooperation outweigh the short-term sacrifices. In this regard, OPEC's quota system has disciplined price hawks who pursue short-term profits and seek to introduce volatility into markets.

Yet the high costs of defection, including the prospect of exclusion from information-sharing and transaction cost-reducing process among members, eventually makes price hawks also obey the rules of unanimity. As a result, populist regimes such as Iran's ultimately do not excessively push for higher prices, even though they are often driven by the need to secure the highest possible profits from their more limited reserves. Moreover, the current Iranian regime cannot afford to politicize OPEC. After all, OPEC's united action last December, led by Saudi Arabia, gave Iran the opportunity to balance the budget and avoid major domestic unrest.

Oil Price Stability and South Korea

In summary, OPEC has sought to guarantee appropriate production quotas, ensure market price stability, and resolve disputes between members. The imperatives of foresight and long-term planning will continue to incentivize members to cooperate to ensure that oil prices do not spiral out of control. In this regard, the United States' sanctions aimed at restricting the sale of Iranian oil are contingent upon the other members of OPEC, especially Saudi Arabia, adjusting their production quotas. However, the cartel's meeting last December appeared to suggest that Saudi Arabia would not seek to fill the gap left by sanctions against Iranian oil.

What are the consequences that these dynamics are likely to have for South Korea? As this *Asan Issue Brief* has tried to show, an appreciation of the difference between short-term volatility and long-term stability is critical. Korea has remained particularly vulnerable to fluctuations in global commodity prices, including oil, due to its geographic location. Situated far from major energy suppliers - whether it is coal and iron ore from Australia and South America, or oil from the Middle East – South Korea has always paid high prices for its energy imports. Given the long transit times required and the absence of any domestic energy reserves, even minor changes in commodity prices have tended to have a disproportionate effect on South Korea's retail oil prices.

South Korea has also been exposed to geopolitical circumstances outside its control. From the Strait of Hormuz to the Strait of Malacca, from the dangers of military blockades to piracy, South Korea's oil trade is contingent upon a variety of international security factors that ensures it pays one of the highest oil prices in Asia. Indeed, given that until last year, Iran was South Korea's fifth-largest supplier of crude oil, accounting for nearly ten percent of its oil imports, the danger remains that a sudden spike in prices will negatively affect the economy. Therefore, efforts to increase trade with countries such as Saudi Arabia and other GCC countries remain essential.

Nonetheless, even as fears continue to mount that the United States' latest round of sanctions against Iran will lead to escalating oil prices, an appreciation of OPEC's record in managing price and supply disruptions should be cause for optimism. For South Korea, while its high exposure to short-term changes in prices indicates that the coming months will be unpredictable, long-term prices are likely to return to more stable figures. While temporary price volatility is an inescapable facet of the geopolitics of oil, there are systemic factors that are conducive to long-term stability. Hence, it is worth noting that the country's economic growth will continue to rely heavily on OPEC's effective control of global oil prices even if Israel strikes Iran's nuclear facilities.

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