Our View: "OPEC+'s Stupid Mistake"

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The United States stripped Saudi Arabia of $100 billion over the last year.

Energy reporters—most of whom appear to be in Saudi Arabia's pocket—seem to believe the Saudis and Crown Prince Mohamed bin Salman have been assertive, confident, and brilliant in managing the oil market. See, for example, "Saudi Arabia Emboldened on World Stage Underpins OPEC Decision." These views are wrong, at least regarding the "brilliant" part. Joe Biden has cut Saudi income by $100 billion (approximately 30%) through the SPR sales announced and begun in March 2022. Most CEOs who lost $100 billion would be fired.

The OPEC+ production cut announced Sunday is a desperate attempt by the Saudis to recover some of the money the United States denied them. Few will note this, though, because the Saudis have pulled the wool over all reporters' eyes.

The organization's decision is also a stupid mistake. The global financial system is facing contagion. Central banks are under pressure to cut rates. At the same time, the European Central Bank has warned that core inflation is far too high. The increase in consumer prices that follows OPEC's output reduction will force central banks to boost interest rates higher. Banks will cut lending as more depositors move their cash to money market funds, which, in turn, will engage in reverse repos with the Federal Reserve. The likelihood of a severe recession has increased.

The OPEC+ decision will embolden those pushing for a rapid shunning of oil, given that crude is now a threat to human survival and global economic stability.

The blame for the coming price rise lies squarely with Saudi Arabia's Crown Prince Mohammed bin Salman, who needs a large cash flow to fund his grandiose development dreams.

This action assures his vision will not be fulfilled. Former Saudi oil minister Sheik Yamani, speaking of oil's future, once warned that "the stone age did not end for lack of stones." Soon MBS will be eating some of those rocks.

In one of the first dispassionate statements on the cut, Argus Media ran the following:

> London, 2 April (Argus) — Eight members of the Opec+ oil producers' alliance announced on Sunday a surprise "voluntary" collective output cut totaling 1.157mn b/d which will take effect from May.
>
> The unexpected decision, announced just a day ahead of Monday's meeting of Opec+'s joint ministerial monitoring committee (JMMC), comes against a backdrop of recent weakness in oil prices, which dipped in March to their lowest level since December 2021, related to fears of contagion in the global banking sector following the collapse of California's Silicon Valley Bank and the ensuing rescue of Switzerland's Credit Suisse.

We view the production cut as one of the most stupid decisions ever made by the organization. We are also fairly certain the decision was driven by the greed of Saudi Arabia's tyrant, Crown Prince Mohamed bin Salman (MBS).

The decision is stupid because it was taken at a time of global financial fragility. As we note below, the World Bank has warned that the global economy could be facing a "lost decade." As we explain, the world's financial system has been weakened by the increasing sums of money moving from bank deposits to money market funds and, in the United States, from there to the Federal Reserve through reverse repos. This movement has tightened the money supply.

As it happens, we had asked a friend who is a voter on a major central bank's monetary committee whether this movement is equivalent to quantitative tightening (QT), a process central banks use to reduce the money supply. The response came today:

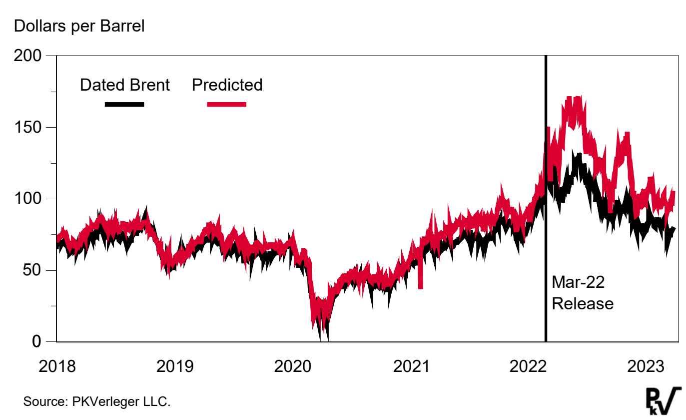
> This is tightening through the credit system. Wouldn't call it QT – think about the Balance Sheet. There is a question of whether such active use of RR [reverse repos] by MMF [money market funds] is in the interest of monetary policymakers [emphasis added].

In the US, the stupid OPEC+ action will likely accelerate the shifting of funds to the Fed. Further upward pressure on interest rates and a greater risk of spreading contagion will result.

The OPEC+ action might also put upward pressure on consumer prices. On Friday, the US had good news on inflation that suggested the Federal Reserve might relax its aggressive tightening. The European Central Bank, though, seems bent on doing the opposite. Below we quote from one ECB board member who warned companies to accept lower margins and profits to reduce pressure on prices. If they do not, interest rates will rise because the higher margins will work into inflation and push prices up. The US central bank may follow the same course.

We blame the idiotic OPEC+ action on MBS. MBS has grandiose goals for Saudi Arabia that include Neom, a futuristic city. He needs boatloads of money to build it. No doubt the recent oil price declines have frustrated him.

Figure 1
Actual Dated Brent Prices vs. Crude Price Predicted by PKVerleger LLC Product Netback Model, 2018 to 2023



Source: PKVerleger LLC.

MBS may also be distressed by President Biden's use of strategic stocks to drive down crude prices while product prices remained high. As we have written previously, the president's actions broke the traditional crude/product price arbitrage. As Figure 1 illustrates, the difference between the crude price predicted from changes in petroleum product prices and the actual crude price, which in the past averaged around $5 per barrel, ballooned to $27 per barrel. Over the last year, Biden's intervention in the world oil market has cost Saudi Arabia and

MBS more than $100 billion. This represents roughly a twenty-five percent cut in revenue from what the Saudis might have earned.

It is hardly a surprise, then, that experts on Saudi Arabia such as RBC Capital Markets' Helima Croft explained that Saudi Arabia was following an economic strategy independent of the United States. Even as MBS blusters, he must be furious that Joe Biden picked his pocket for a cool $100 billion.

OPEC's stupid action should be welcomed by those who want a rapid transition away from fossil fuels. Two tyrants, MBS and Vladimir Putin, have united in an effort to boost their income from fossil fuels. Putin led by cutting gas supplies to Europe, expecting a quick capitulation. Instead, Europe has since ended its reliance on Russian gas. Russia's economy will be decimated, frustrating the dream he postulated in his doctoral thesis for St. Petersburg State Mining University. The Saudi action will have a similar effect on the oil market unless other oil exporters realize that MBS is hastening the stranding of a large part of the world's fossil fuel reserves.

In the short term, though, the World Bank's warning must be heeded. The prospect of ten years of lost economic growth offers nothing good for the world. Yes, oil use will drop. But exacerbated poverty, starvation, and financial turmoil will be the cost.