Will an oil price cap manage to reduce the flow of revenue to Russia?

In early September 2022, the finance ministers of the G7 countries confirmed their intention to implement a price cap on purchases of Russian oil and related products. Their objective is to reduce Russia's ability to fund its invasion of Ukraine while limiting the war's impact on global energy prices. A survey by the Initiative on Global Markets asked economists for their thoughts on price caps. ***Romesh Vaitilingam*** *summarises the results.*

We invited our European and US experts to express their views on this proposal, asking both panels whether they agree or disagree with the following statements, and, if so, how strongly and with what degree of confidence:

a) A price cap imposed by the G7/EU countries on purchases of Russian oil and oil-related products (and which applies to all importers of Russian oil using Western trade infrastructure, shipping, and insurance) would be an effective measure to reduce the flow of revenues to Russia.

b) The oil price cap imposed by the G7/EU countries will not have a substantial effect on the world oil price (such as the Brent crude benchmark).

The price cap and Russian revenues

Of our 43 US experts, 39 participated in this survey; of our 49 European experts, 38 participated – for a total of 77 expert reactions. On the first statement, over two-thirds of the panellists agree or strongly agree with the statement (among whom European experts were more likely to say that they strongly agree), most of the rest are uncertain, and a few disagree.

Weighted by each expert's confidence in their response, 16% of the European panel strongly agree, 57% agree, 20% are uncertain, 4% disagree, and 4% strongly disagree (totals don't always sum to 100 because of rounding). Among the US panel (again weighted by each expert's confidence in their response), 5% strongly agree, 59% agree, 28% are uncertain, and 8% disagree. Overall, across both panels, 11% strongly agree, 58% agree, 23% are uncertain, 6% disagree, and 2% strongly disagree.

More details on the experts' views come in the short comments that they are able to include when they participate in the survey. Among those who agree or strongly agree with the statement, Maristella Botticini at Bocconi argues: 'Price caps (and floors) typically generate distortions. True. But in extraordinary times, like during a war after a pandemic, policy recommendations based on EC101 models should become more sophisticated. A temporary price cap together with other policy measures can help a lot.'

Richard Portes at London Business School (LBS) points out that: 'Russia is already selling oil to India and China at substantially discounted prices. And the oil price is responding to demand, not significantly affected by speculation. Russia will have few alternative major buyers at prices above the cap, provided that is set sensibly.' Olivier Blanchard at the Peterson Institute also refers to the importance of where the cap is set: 'A well designed price cap, just such as to give Russia the incentive to sell at the cap rather than just stop selling. Want to affect revenues, not quantities sold. Hard to do right.'

David Autor at MIT also considers implementation difficult to get right: 'It's a great idea in theory but hard to enforce in practice. The cap will likely depress Russian oil revenue somewhat, in part by enabling China, Iran, and North Korea to negotiate a greater discount (though above the price cap).' But Kenneth Judd at Stanford is optimistic: 'Exercising monopsony power will push down revenues to Russia. They may find other buyers but the mechanics of moving oil will limit that leakage. Hopefully diplomatic efforts will convince potential buyers to not increase their purchases.'

Several experts who agree with the statement wonder how large the effect could be. Ricardo Reis at the London School of Economics (LSE) says: 'Effective to reduce the flow of revenues to Russia, but unclear how large. Depends, in the short run on response of non-G7/EU government, and in the long run on entry into market of non-G7/EU traders/shippers/financiers.' He links to a useful overview of the issues at The Economist.

Judith Chevalier at Yale replies: 'While leakage will be large, the sanctions plus price cap should improve the bargaining position of non-G7 countries vis-à-vis Russia and reduce Russian revenues. There appears to be some evidence that Russia is currently deepening the discounts to India.' She adds a link to recent Brookings Institution discussion of whether capping the price of Russian oil will happen and, if so, whether it will succeed.

Two panellists refer to issues around insurance. Helene Rey at LBS states: 'Depends on "leakages"; in particular how easy it is to find non-compliant insurance companies for the shipments.' And Barry Eichengreen at Berkeley asks: '95% of insurance underwriting for oil tankers is provided by G7 consortia. How long, though, before the Chinese begin to substitute?'

Others who agree with the statement mention alternative measures for sanctioning Russia. Jan Eeckhout at Universitat Pompeu Fabra in Barcelona says: 'A tax would be better as it reduces income to Russia and provides the right incentives to look for other sources (at lower prices). The complication is that Russian oil/gas is effectively a state monopoly (even private firms must follow the Kremlin) that can ration.'

Rick van der Ploeg at Oxford suggests that: 'A boycott of oil would be better. For oil (not gas), some of it will be sold instead at a discount to China and India. Hence, oil from Saudi Arabia will become available for the West and thus price of oil may fall.' Daron Acemoglu at MIT takes a different view: 'There are of course difficulties because the oil market is global and there will be supply diversion. But better than pure sanctions.' Patrick Honohan at Trinity College Dublin, one of the panellists who say they are uncertain, also mentions alternative measures: 'Far from fully effective and not as good as a selective tax on imports of Russian energy products.'

Christian Leuz at Chicago is also uncertain, noting: 'In theory, it should but there are many practical questions as to whether the cap will work. For pros and cons, see links below. On balance, a cap likely reduces Russia's oil revenue by some, but it is unclear how big the effect will be.' He links to recent commentaries by the journal Foreign Policy and at the Carnegie Endowment for International Peace.

Others express similar views. Christopher Udry at Northwestern observes: 'There may be enough frictions in the oil market that this could have some effect.' Oliver Hart at Yale remarks: 'It will reduce Russian revenues but the question is by how much. Given that there are many ways around the price cap and oil can be re-sold, the price cap may not be that effective.' And Anil Kashyap at Chicago declares: 'If you forced me to bet, I would guess revenues fall but magnitude seems uncertain and will depend on lots of the details about implementation. Also depends on willingness of other countries outside the cartel to re-export.'

Further uncertainties are mentioned by Darrell Duffie at Stanford: 'If the price of Russian oil goes down relative to the price of non-Russian oil, would sales of Russian oil rise through substitution? And what about leakage around the cap? I'm uncertain of the overall effect.' Franklin Allen at Imperial College London adds: 'How effective it will be depends on how much the measure is enforced by US secondary sanctions and other means.' And Pinelopi Goldberg at Yale concludes: 'There are many implementation details and logistics that the G7/EU still needs to figure out.'

Among the experts who disagree, Richard Schmalensee at MIT warns: 'I think the cap would be leaky, particularly beyond the very short run.' And Pete Klenow at Stanford points to evidence on how sanctioned countries might respond in the experience of a United Nations exemption from sanctions against Iraq around the turn of the century, via which the country was able to collect revenues from bribery for underpricing its oil.

The world oil price

On the second statement about the price cap not affecting the world oil price, just over a half of panellists agree, a third are uncertain and the rest disagree. Weighted by each expert's confidence in their response, 13% of the European panel strongly agree, 46% agree, 30% are uncertain, and 11% disagree. Among the US panel (again, weighted by each expert's confidence in their response), 4% strongly agree, 46% agree, 40% are uncertain, 6% disagree, and 5% strongly disagree. Overall, across both panels, 8% strongly agree, 46% agree, 35% are uncertain, 8% disagree, and 2% strongly disagree (again, totals don't always sum to 100 because of rounding).

Among the comments of those who agree, there are several caveats. Agnes Benassy-Quere at the Paris School of Economics notes: 'Two opposite effects: higher global supply, but also higher global demand due to the cap.' Kenneth Judd says: 'World oil prices depend on world supply. This will affect world supply and price only if Russia substantially cuts its production, which is unlikely. However, Russian production cuts would hurt Russia even more. The resulting price increase would be a reasonable cost for us.' And Richard Portes replies: 'Russia is not that big a share of the global oil market. If they can convince OPEC to cut supply significantly, then the story is different, of course.'

Among the panellists who say they are uncertain, several mention variables that will determine the outcome. Rafael Repullo at CEMFI, Madrid observes: 'It will largely depend on how Russia reacts to the cap.' Jonathan Levin at Stanford adds: 'Likely depends on whether the quantity of oil exported by Russia falls significantly.' Christian Leuz notes: 'The effect on price is hard to predict as it depends on how Russia and also China and India respond to the cap.' And Franklin Allen states: 'It probably won't have much effect unless the cap works well. There are probably many ways around the cap.'

For David Autor, there are: 'Too many unknowns. It could even raise the Brent crude price by injecting even more uncertainty.' Maurice Obstfeld at Berkeley concurs: 'Could go up if Putin stops oil exports because the financial benefit is less than the perceived political benefit of squeezing the West further.' And Olivier Blanchard explains: 'Complex: If price cap leads Russia to stop selling to the cappers and cannot fully reallocate to other buyers, there is a decrease in world supply and increase in the market price. If Russia sells to price cappers, then no obvious major effect on the remaining market price.'

Finally, Rick van der Ploeg, one of the minority who disagrees, reiterates: 'As I already said, China and India will buy from Russia oil at a discount rather than from Saudi Arabia and others. Hence, this will lower the price of oil for the West too.'

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Notes:

- *This blog post summarises a survey by the University of Chicago Booth School of Business' Initiative on Global Markets. The full survey results for the European and US panels include all comments made by the experts.*
- *The post represents the views of its author(s), not the position of LSE Business Review or the London School of Economics.*
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