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Oil Prices Rising Despite OPEC-plus Decision on Production Increase

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Crude oil prices are rising gradually. On June 8, the front-month contract on the U.S. benchmark West Texas Intermediate crude closed at $122.11 per barrel, up $2.70/bbl from the previous day, rising close to the recent high of 123.70/bbl that was reached on March 8 when the United States, Canada and the United Kingdom announced their respective energy embargoes on Russia. The key futures contract on the European benchmark Brent crude finished at $123.58/bbl, up $3.01/bbl, nearing the March 8 high of $127.98/bbl.

The OPEC-plus group of oil-producing countries at its ministerial meeting on June 2 decided to accelerate its monthly production increase from 0.43 million barrels per day to 0.65 million bpd in July and August. The group had rejected major oil-consuming countries' repeated requests for an accelerated production increase over more than six months since crude oil prices' rise above $80/bbl last autumn. They had attributed crude oil price hikes to the geopolitical risk premium rather than supply and demand factors, concluding that their planned or scheduled monthly production increase would be enough.

At last, however, the group turned to the accelerated production increase at its latest meeting. One apparent reason for the OPEC-plus decision may be that the European Union's announcement of a Russian oil embargo changed the group's market assessment. Although pipeline oil imports from Russia were excluded from the Russian oil embargo due to Hungary's strong opposition to a full embargo, the EU's demonstration of its unity towards the embargo indicated a specific pathway to the embargo, beginning to exert upward pressure on crude oil prices.

The EU's Russian oil embargo may lead Russia to sell EU-bound unsold oil at discounts to China, India and other oil-consuming countries that do not participate in Russian oil embargoes. If a Russian export decline under the EU embargo is smaller than an increase in Russian exports to China and India, a drop in Middle Eastern and other non-Russian oil imports into the two countries may be smaller than a cut in Russian imports into the EU, resulting in a tighter global supply-demand balance. Changes in oil flow among Europe, Russia, China, India and the Middle East may not be limited to oil supply dislocation but close to disruption accompanied by a supply decline or a tighter supply-demand balance. Oil market participants anticipate such condition, exerting upward pressure on crude prices.

Concerned about a potential increase in crude oil prices and its adverse impact, the United States has enhanced its request for the OPEC-plus group, including its leader Saudi Arabia, to increase production further, contributing to the latest OPEC-plus decision to accelerate its production increase. The U.S. Biden administration, plagued with its falling approval rates amid the gasoline price spike, has been politically eager to win the accelerated OPEC-plus production increase to suppress oil prices. However, Saudi Arabia had refused to meet such U.S. request over the past six-plus months due to their special relationship having soured.

The Biden administration under its value-oriented foreign policy giving priority to human rights and democracy has taken a tough attitude against Saudi Arabia over the killing of a Saudi journalist and other problems, affecting the U.S.-Saudi relationship, according to some analysts. As concerns have grown about crude oil price hikes and international energy market destabilization, however, the United States and Saudi Arabia might have attempted to reconstruct their relationship through various contacts behind the scenes. Some reports say that the two countries could arrange a bilateral summit. In such situation, the OPEC-plus group announced a policy change to accelerate its oil production increase.

Such OPEC-plus policy change to additionally increase production should have calmed down crude oil prices. As noted at the outset of this report, however, crude oil prices have retained an upward trend. Why?

In summary, market participants have conceived that the decision to accelerate the production increase was designed to exert downward pressure on crude oil prices but has failed to be enough to do so. First, the actual production increase is expected to slip far below the target production increase raised to 0.65 million bpd from 0.43 million bpd for the entire OPEC-plus group that includes the Organization of the Petroleum Exporting Countries, Russia and others.

The target for the entire OPEC-plus group includes a target for Russia, meaning that the production quota for Russia is raised. As the EU's Russian oil embargo takes effect, however, a Russian oil production decline may accelerate, resulting in actual production greatly deviating from the overall OPEC-plus target. Before the latest OPEC-plus meeting, Russia had been reportedly expected to be excluded from the additional production increase. In fact, however, OPEC led by Saudi Arabia might have given priority to the maintenance of its cooperation with Russia, leading to the latest decision.

Furthermore, many OPEC members have been producing crude oil at their full capacity and have no room to expand production to meet the raised target. In this sense, only some OPEC members including Saudi Arabia and the United Arab Emirates with sufficient surplus production capacity can actually increase production. The accelerated production increase of 0.65 million bpd is thus expected to end up as a pie in the sky. In this sense, Saudi Arabia and other OPEC members with surplus production capacity hold the key to addressing crude oil price hikes and market destabilization.

There is another attention-attracting point regarding demand. That is the Chinese economic trend. Crude oil prices will be sensitive to how the Chinese economy will recover from COVID-19 lockdowns. In general, global economic developments will exert influence on future oil demand and prices. However, oil market participants pay attention to the fact that China, the largest oil importer in the world, has faced economic deceleration due to COVID-19 lockdowns and to the possibility that Chinese oil demand could recover on the recent lifting of the lockdown in Shanghai. Depending on China's oil demand trend, crude oil prices may come under upward or downward pressure.

Further hikes in crude oil prices and international oil market destabilization will greatly affect civic life and economic activities. They may further accelerate inflation that has become a great matter of concern in Western countries. This is a serious problem for all oil consuming and importing countries. For Japan and other countries with low energy self-sufficiency rates, the problem will bring about massive national wealth outflow. As liquefied natural gas prices for Japan are indexed to crude oil prices, oil price hikes will lead to higher LNG procurement costs that may be coupled with coal price hikes to push up electricity costs. Given that crude oil price hikes exert great influence on Japan's economy, industries and manufacturers as well as its civic life and society, we must be alert to the future oil price trend.

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