Special Bulletin

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Oil Prices Down on U.S. Banking Crisis with Brent below $80/bbl for the 1st Time in 2 Months

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Crude oil prices have rapidly fallen since last weekend. On March 14, the front-month futures contract for Brent crude plunged by $3.32 per barrel from the previous day to $77.5/bbl on a closing price basis, slipping below $80/bbl for the first time in two months, since January 9. The key West Texas Intermediate futures price also dropped $3.47/bbl to $71.33/bbl, the lowest since last December 9, nearing the psychologically important barrier of $70/bbl.

The oil price plunge came on a U.S. banking crisis triggered by a major U.S. bank failure that dominated economic news headlines in the world over the past several days. On March 10, U.S. financial authorities announced that California-based Silicon Valley Bank had become insolvent and collapsed. The bank, known for aggressive investment in information technology startups, was the 16th largest bank, with assets totaling $209 billion as of the end of 2022. The collapse marked the second-largest U.S. bank failure in history, following the bankruptcy of Washington Mutual Bank with $307 billion in assets in September 2008. On March 12, U.S. financial authorities announced that New York-based Signature Bank had failed. The bank had dealt mainly with crypto asset companies and was the 29th largest U.S. bank, with assets totaling $110 billion. The successive major bank failures shook financial markets.

Factors behind the major U.S. bank failures include the adverse effects of U.S. interest rate hikes. Silicon Valley Bank invested heavily in U.S. Treasury bonds and saw massive unrealized losses on bond holdings due to substantial bond price falls caused by rapid interest rate hikes since 2022. Monetary tightening through interest rate hikes also hit startups and prompted them to withdraw deposits from the bank. Insecurity about the bank's financial profile and creditworthiness spread fast and led the bank's stock price to nosedive, resulting in the failure. As for Signature Bank, interest rate hikes for monetary tightening affected crypto asset companies as its clients amid financial insecurity caused by the Silicon Valley Bank failure, leading to a rapid increase in deposit withdrawals and a decline in liquidity, a vicious cycle that ultimately forced the bank to collapse.

The successive major bank failures have seriously affected financial markets. The Dow Jones average on the New York stock exchange fell below 32,000 on March 10 and dropped to 31,819 on March 13. On currency markets, the dollar fell below 133 yen temporarily on March 13. As risk-off moves grew, prices soared for gold, which is seen as safe haven asset. The gold futures price rose to $1,916.50 per ounce on March 13. In such financial market situation, crude oil prices plunged amid risk-off moves and the loosening supply-demand balance.

U.S. authorities quicky reacted to the financial market turmoil and insecurity. The Department of Treasury, the Federal Reserve Board and the Federal Deposit Insurance Corporation published a joint statement on March 12, vowing to protect all depositors. President Joe Biden told a press conference on March 13 that the banking system was safe and that people should be secure. Such actions have led to restored stability in financial markets.

Following the major bank failures and the market turmoil, the next focus of attention is what to do with interest rate hikes as one of factors behind the turmoil. As noted in my previous special bulletin (627), the next meeting of the Federal Open Market Committee is attracting attention after Federal Reserve Chairman Jerome Powell's remarks on interest rate hikes induced a stock market plunge. Market players may be interested in how the bank failures would influence the next FOMC meeting. The bank failures might have made it more difficult for U.S. monetary authorities to steer monetary policy.

U.S. monetary tightening and subsequent economic deceleration are expected to cause a decline in oil demand, which would loosen the supply-demand balance. The risk-off trend is inducing crude oil futures selling. U.S. financial market trends thus now exert downside pressure on crude oil prices. We will have to pay attention to how the FOMC would handle monetary policy at its next meeting and whether the insecurity triggered by the bank failures would calm down in a manner to lead U.S. financial markets to restore stability.

As noted in my previous special bulletin, Chinese economic trends are likely to support or push up crude oil prices. On March 15, the National Statistics Bureau of China announced major economic data for January and February. Retail sales that indicate consumption trends scored a year-to-year rise of 3.5% in the two months after declining for three consecutive months. Industrial production in the two months increased by 2.4% year on year, indicating a recovery. These economic data improvements are believed to have resulted from the termination of the zero-COVID policy late last year. However, the Chinese economic picture is still patchy. Real estate investment in the two months decreased by 5.7% year on year, indicating that the real estate sector is still sluggish. U.S. economic deceleration may affect Chinese exports. Overall, however, market players are feeling that the Chinese economy is indicating signs of a recovery. Their interest in the Chinese economic recovery will grow further in the future.

As the WTI price falls close to $70/bbl, a response from the OPEC-plus group of oil-producing countries will attract attention from oil market players. The current OPEC-plus oil production policy calls for cutting production between November 2022 and December 2023 by 2 million barrels per day from October 2022, as decided at the group's ministerial meeting last December. The next ministerial meeting is scheduled for June 4, 2023. However, the OPEC-plus group also decided to take any action as necessary, indicating that the group could promptly respond to major crude oil price fluctuations.

If the WTI price slips below $70/bbl, with a downtrend expected to continue, however, the OPEC-plus group is unlikely to leave such downtrend untouched, as indicated by its past actions. The group may be alert to current U.S. financial market, economic and oil demand trends. While market players dominantly expect the oil supply-demand balance to tighten towards the second half of this year due to a demand increase mainly in China, the balance has the potential to loosen in the first half. The market may move in a manner to test the OPEC-plus group over its oil production policy.

If the OPEC-plus group takes actions to prevent oil prices from falling or boost them at a time when the U.S. economy is decelerating, tensions may arise between the United States and the group led by Saudi Arabia. As far as crude oil prices remain in a narrow range, the equilibrium of relations among major oil market actors will continue. If crude oil prices rise or decline sharply or any policy actions cause a sharp crude oil price change, however, the equilibrium may collapse in a manner to heighten tensions. We will have to closely watch future oil market moves and relevant geopolitical developments.

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