Special Bulletin

 July 11, 2018

2018 January-June Prices Averaged $71.1 for Brent and $65.5 for WTI

Ken Koyama, PhD
Chief Economist, Managing Director
The Institute of Energy Economics, Japan

Crude oil futures prices (front-month contracts' daily closing prices) averaged $71.13 per barrel for Brent and $65.46/bbl for West Texas Intermediate in the January-June 2018 period. From the same period last year, the average rose by $18.5/bbl or 35% for Brent and by $15.5/bbl or 31% for WTI. The highest price in the first half of 2018 was $79.80/bbl on May 23 for Brent and $74.15/bbl on June 29 for WTI. The lowest was $62.59/bbl on February 12 for Brent and $59.19 on February 13 for WTI. In the beginning of the year, Brent rose above $70/bbl for the first time since November 2014. It fell back slightly later, crept up from February and chased higher ground from May. WTI rose beyond $70/bbl in May and hit a peak for the six-month period in late June as noted above. Briefly, Brent rose above $80/bbl on May 17 for the first time since November 2014.

Factors behind the substantial year-on-year increases in crude oil futures prices include the international oil market's rebalancing (toward the disappearance of oversupply or supply-demand equilibrium). Global oil inventories, represented by private sector inventories in the member countries of the Organization for Economic Cooperation and Development, continued expanding from early 2014 to late 2016, reaching an unprecedentedly high level. However, the excess inventories decreased steadily in 2017 and fell back to the five-year average level recently. The reduction of oversupply toward supply-demand equilibrium in the international oil market has been the most important fundamental factor behind the oil price hike. Amid the trend toward supply-demand equilibrium, the crude futures market sensitively responded to geopolitical risks and disruptions to oil supply that came one after another mainly in major oil producing countries in the Middle East, accelerating the price hike.

In the most typical event in the period, the United States announced to exit from the Iran nuclear deal in a manner to escalate geopolitical risks in the Middle East. On May 8, U.S. President Donald Trump vowed to withdraw the United States from the Iran nuclear deal that he had harshly criticized since the presidential election campaigns. As a result, Iranian crude oil exports are expected to decline substantially from the latest level of more than 2 million barrels per day under U.S. economic sanctions to be restarted. The event has led the Iranian situation to grow more fluid, indicating the potential further escalation of geopolitical risks in the Middle East.

Crude oil prices soared in response to the growing geopolitical risks in May. In the wake of the price hike, the Organization of the Petroleum Exporting Countries at its regular general conference and its meeting with Russia and other non-OPEC oil producing countries in June decided to ease their coordinated production cut and effectively increase output from July 1, sending a message that they would make up for the expected decline in oil supply from Iran and actual production falls in such countries as Venezuela. Given that the "ambiguous decision" fell short of clarifying the effective production increase or its country-by-country breakdown, however, crude oil prices remained high after the OPEC conference. Crude prices rose even further in late June as the

Iranian situation grew more tense, with the United States asking major oil importers from Iran to take no delivery of Iranian oil.

After such market developments, two major factors are seemingly pushing the international oil market in diametrically opposite directions.

The first factor is a potential plunge in oil supply in the international oil market toward the end of this year. Market participants are paying great attention to Venezuela where oil production has declined below 1.4 million barrels per day from 2 million bpd in 2017 and is expected to decrease further due to economic and social turmoil and to Libya where the situation has recently been destabilized to greatly affect oil production. However, the biggest issue is how far Iranian crude exports would decline by the U.S.-set deadline of November 4 for cutting off oil imports from Iran. Attracting global attention is how major importers of Iranian oil would act in response to the U.S. request for them to cut Iranian oil imports to zero. The key factor is the action taken by China, the largest importer of Iranian oil. Given a scenario envisaging that the international oil market would lose more than 3 million bpd in Iranian, Venezuelan and Libyan oil supply, market players have no choice but to be sensitive to concerns about supply shortages.

The second factor is an insecurity or risk about the future course of the global economy. Fundamental factors that have so far supported crude oil price hikes have been based on the robust global economy and subsequent steady growth in global oil demand. While the global economy is still growing, trade war headlines dominate the world on the escalation of trade disputes between major trading partners, including the United States' disputes with China and with the European Union. The world now sees a vicious circle where additional U.S. tariffs cause other countries' retaliatory measures that trigger U.S. retaliation. Such vicious circle is feared to seriously affect the global economy and international financial markets.

If China's economic growth decelerates on the escalation of trade disputes, particularly, it may exert a great impact on the international oil market or the whole of the international energy market. As China has driven demand expansion in the international energy market since last year, slower Chinese demand growth can be expected to exert downward pressure on crude oil prices. The possible global economic growth deceleration and turmoil in international financial markets could lead "money" to flow out of risky asset markets. Another unignorable downward pressure on oil prices could come from the potential acceleration of U.S. shale oil production growth.

Behind the factors that push the international energy market in opposite directions are U.S. President Trump's policies. The United States is centrally responsible for increasing uncertainties in the international oil market. President Trump, who has no choice but to pay attention to gasoline price hikes ahead of the midterm congressional elections, asked Saudi Arabia to increase oil production by 2 million bpd in response to crude price hikes following his request for other countries to take no delivery of Iranian oil. Under such circumstances, OPEC including Saudi Arabia may attempt to cautiously coordinate oil supply and demand balance in the world market while watching the uncertainties of the two abovementioned market directions. If a large-scale supply decline, cited as the first factor above, emerges, Saudi Arabia may be the only country expected to make major contributions to making up for supply shortages. Future developments in the international oil market will depend on what action or response Saudi Arabia would take in a bid to stabilize the market.

However, another key point is that Saudi Arabia would have little surplus oil production capacity if it substantially expanded oil production to successfully fill a supply-demand gap and achieve a supply-demand equilibrium on a flow basis. In the case where Saudi Arabia’s surplus production capacity would decline substantially, Iran’s oil exports would have remarkably declined, with its domestic situation growing severer. This means that a supply buffer or surplus production capacity to support market stability would have declined substantially, with geopolitical risks being high. The market would be conscious of such situation, leading to very sensitive market developments. We would have to take note of various future oil market developments including the abovementioned potential events.

Contact: report@tky.ieej.or.jp
The back issues are available at the following URL
http://eneken.ieej.or.jp/en/special_bulletin.html