Special Bulletin

A Japanese Perspective on the International Energy Landscape (701) August 9, 2024

Crude Oil Prices Shaken by Global Economic Instability and Geopolitical Risks

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

As new uncertainties have arisen in the outlook for crude oil prices, future developments are attracting attention. In early August, stock markets plunged globally. On August 5, the Dow Jones Industrial Average on the New York Stock Exchange and the Nikkei stock average on the Tokyo Stock Exchange fell sharply, exerting downside pressure on crude oil prices. As stock prices subsequently picked up, however, crude oil prices turned up. Nevertheless, tensions in the Middle East have intensified over Iran and Israel, forcing markets to brace for the development of geopolitical risks. Depending on how these two important factors unfold in the future, the global economy and the international situation will be affected significantly, leading crude oil prices to swing significantly both upward and downward.

In early August, stock markets were shaken significantly. On the New York Stock Exchange, the Dow Jones Industrial Average lost 495 points on August 1 and plunged by 611 points to 39,737 on August 2, after remaining above 40,000 in July. As market turmoil failed to subside on August 5 after a weekend, the average suffered a 1,034-point plunge, sinking to 38,703.

On the Tokyo Stock Exchange, the Nikkei average posted an even sharper decline. After hitting an all-time high above 42,000 in mid-July, it gradually declined in the second half of the month, reaching 39,102 on July 31. The Nikkei average fell by 975 points to 38,126 on August 1 and by 2,217 points to 35,910 on August 2, before plunging by 4,451 points to 31,458 on August 5. It lost more than 7,600 points in three market days, falling more than 10,000 points from the record high in July. The sharp stock market decline was not limited to New York and Tokyo but spread to Europe and Asia. Until the beginning of August's second week, the global stock market crash shook global financial markets.

Behind this global stock market crash have been uncertainties about the outlook for the global economy, especially the U.S. economy and the Chinese economy. I refrain from commenting on Chinese economic issues that were covered by my previous essay -- A Japanese Perspective on the International Energy Landscape (700). In the United States, with the world's largest economy, as well, anxiety and concerns have grown about the economic outlook. In particular, the July jobs report included a slower-than-predicted increase in nonfarm payrolls and an unemployment rate of 4.3%, the highest since October 2021, making market participants nervous about the outlook for the U.S. economy. As a result, anxiety grew about a hard-landing economic slowdown accompanied by a sharp deterioration, dampening the mainstream view that the U.S. economy would make a soft landing. This might have triggered the flight of funds from risk assets.

Heightened uncertainties about the U.S. economic outlook led to widespread speculation that the U.S. Federal Reserve would cut interest rates, bringing about various ripple effects in a sense. In late July, the Bank of Japan at its monetary policy meeting decided to raise interest rates further, triggering the Japanese yen's rapid appreciation against the dollar and a Japanese stock market decline. The yen appreciated against the dollar on Japan's decision to raise interest rates and the expectation of U.S. rate cuts, causing a reversal of carry trade positions that might have accelerated the stock market decline. The carry trade, in which investors raised yen funds for investment in view of Japan's ultralow interest rate policy, produced losses due to the yen's appreciation and the BOJ's rate increase, leading investors to sell shareholdings to cover carry trade losses, according to market sources. In the midst of this vicious cycle, panic selling brought about stock market crashes in Tokyo and New York.

Heightened uncertainties about the outlook for the global economy were combined with the withdrawal of funds from risk assets to exert downside pressure on crude oil prices. The daily closing price of the front-month futures contract for the West Texas Intermediate crude dropped by nearly $5 per barrel from $77.91/bbl on July 31 to $72.94/bbl on August 5. Crude oil prices had been on a downward trend since the beginning of July due to concerns about the global economy, particularly the Chinese economy, before being destabilized by the global stock market crash.

However, stock markets have restored a certain level of stability since August 6, avoiding a free fall. The Dow Jones Industrial Average gained 294 points on August 6, halting its decline. After falling back by 234 points the next day, it posted a sharp rally of 683 points to 39,446 on August 8. The Nikkei average staged a steep rally of 3,217 points on August 6 after the previous day's historic crash. It gained 414 points on August 7 and fell back by 258 points to 34,831 the next day. The rally came as buybacks swelled in reaction to the excessive crash on August 5, with economic indicators contributing to preventing further stock market deterioration. As a result, crude oil price falls came to a halt, with WTI rising back to $76.19/bbl on August 8. Since the beginning of August, global financial markets have thus been turbulent due to the stock market crash, leaving future developments unpredictable. Would global financial markets make a soft landing or a hard landing? Depending on future developments regarding the U.S. economy, the Chinese economy, and the global economy, the markets could fluctuate wildly again.

Meanwhile, another important uncertainty factor that could have a direct significant impact on the crude oil market is attracting global attention. Geopolitical risks could shake the international situation due to the potential escalation of tensions in the Middle East. On July 31, the Palestine Hamas group, locked in fierce fighting with Israel, announced that its top leader Ismail Haniyeh was killed by Israel while he was visiting Tehran to attend the inauguration of Iran's new President Masoud Pezeshkian. Hamas vowed to retaliate against the Israeli action, with revenge against Israel pledged by Iran, where the Hamas leader was killed. When and how Iran, Hamas, and their supporters would retaliate against Israel has become a matter of great concern to the world. Although Israel has not officially acknowledged the killing, it has warned that retaliation and attacks against Israel would have serious consequences.

For Iran, where a key person invited to the inauguration ceremony of the new president was killed, retaliation against Israel is an obligation and inevitable. However, Iran hopes to avoid any situation in which its retaliation against Israel would escalate into a full-fledged confrontation with Israel and the United States. When Iran and Israel carried out missile attacks on each other in April, Iran exercised self-restraint to avoid such escalation, calming down the situation. This time, too, the United States, Europe, Russia, and Iran's Middle East neighbors have urged Tehran to exercise self-restraint. Iran itself hopes to avoid any escalation, as noted above. Once retaliation is implemented, however, it cannot be ruled out that there will be any unforeseen circumstances or uncalculated events. There are growing concerns that retaliation could lead to a scenario where the Middle East as a whole would be destabilized in a manner to affect its oil supply. In the worst-case scenario that affects oil supply from the Middle East, oil prices could rise sharply.

Crude oil prices will thus continue to be shaken by the global economic instability symbolized by the stock market destabilization and the Middle East situation. Caution is required in the future.

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