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Growing Uncertainties in the World Oil Market and Crude Oil Prices
-- Next OPEC Meeting Attracting Attention --

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As crude oil prices have remained high, the international oil market situation has grown even more uncertain. The benchmark West Texas Intermediate crude futures price averaged $99.0 per barrel between January and May 2011, up $19.9 or 25% from a year earlier. The price rose to a year-to-date high above $113/barrel in early May and fell back below $100/barrel before remaining around the level. Under such situation, various factors have worked intricately over the future direction of the market, with both upside and downside risks growing for crude oil price in the future. Crude oil futures transactions, futures market speculations and financial effects are very important for crude oil price formation nowadays. However, this report focuses on supply and demand factors that can exert substantial influence on market expectations, speculations, financial factors and market players' behavior.

The biggest factor behind the downside risks is a fear or uneasiness about the future course of the world economy. The April 2011 World Economic Outlook of the International Monetary Fund left the projection of world economic growth unchanged from 4.4% in the previous outlook released in January 2011. But it revised downward economic growth projections for the entire Organization for Economic Cooperation and Development and major countries including the United States and Japan. At the same time, the European sovereign crisis has remained unresolved in the market as indicated by Greece whose sovereign bond rating has recently been lowered by two to three notches to trigger rapid government bond price falls (yield hikes) after the emergence of its budget crisis last year. Even in the United States where production and employment have signaled signs of recovery amid firming stock prices, March's housing price index that has great influences on private consumption posted the lowest level since the financial crisis, adding to economic fears. Japan is certain to revise downward its economic growth projection due to the March 11 Great East Japan Earthquake.

Under such situation, the future course of global oil demand has attracted attention. In a conspicuous development in this respect, the May 2011 "Monthly Oil Market Report" by the International Energy Agency sharply lowered its projection of a global oil demand increase for 2011 from the previous month's forecast to 1.29 million barrels per day. The IEA cited high crude oil prices as a reason for lowering the oil demand projection. But economic growth may still be a major factor that exerts a decisive influence on oil demand. Although the destabilization of the Middle Eastern and North African situation as a geopolitical risk had exerted great upward pressures on oil prices since the second half of February as discussed later, the situation is now deadlocked, possibly reducing its impact on the market expectation. Therefore, any data indicating weak economic fundamentals may affect financial players' behavior in the oil market and trigger a decline in oil prices.

But we must pay attention to the fact that bullish factors for oil price coexist with bearish ones and are exerting influences on the oil market. Particularly, the global oil supply-demand balance and relevant moves of the Organization of Petroleum Exporting Counties are attracting attention. Although Libya's substantial reduction in crude oil production, which came on a Libyan rebellion amid the Middle Eastern and North African destabilization, was a major factor behind crude oil price hikes in and after the second half of February, OPEC countries including Saudi Arabia have temporarily increased their oil output to cover the lost Libyan production. While the production increase has worked to offset oil supply reduction, the whole of OPEC's surplus production capacity as a major buffer for the stabilization of the market has declined. This has triggered next-stage fears as geopolitical risk is expected to increase.

Furthermore, we have recently seen an emerging recognition that the temporary OPEC output expansion has fallen short of covering the Libyan oil output loss. This is an important point. One problem is that while Libya reduced output of high-quality crude oil containing less sulfur, an OPEC output expansion represented different-quality crude. However, a more significant factor is that the 12 OPEC countries' crude oil output in April decreased by 1.13 million bpd from February's 30.08 million bpd to 28.75 million bpd, according to the IEA statistics. The drop is close to the Libyan production cut (1.19 million bpd). The change indicates that production by OPEC countries other than Libya leveled off from February to April. Given this fact, observers have speculated that OPEC countries could be cautious toward substantial supply expansion and could be raising their desirable price levels (strengthening their pursuit of higher crude oil prices) to cope with domestic economic and budget balance problems and to secure income for domestic stabilization measures, as the benchmark crude oil futures price far exceeded $100/barrel after the Libyan crisis, with fears about the price hikes' adverse effects on the world economy growing among major oil consuming countries. Therefore, OPEC's response to the global oil demand increase (despite its downward revision by the IEA) is attracting attention while market players are expecting an expansion in calls on OPEC.

As OPEC plans to hold its 159th general meeting in Vienna on June 8, the abovementioned market situation has prompted market participants including financial players to pay attention to OPEC responses. OPEC has left their production quotas unchanged since it lowered the quotas effective from January 2009 by 4.2 million bpd (from the actual output level in September 2008) to cope with a sharp oil price decline after the global financial crisis. Since then, OPEC has actually continued to adjust their crude oil production to meet supply and demand conditions in the market, allowing the rate of compliance with the agreed production cut to slip below 70%. Production quotas have effectively been meaningless in a sense. While OPEC is somewhat expected to increase output (or change production quotas officially) to help stabilize the market as discussed above, we must pay attention to OPEC's coming decision responding to both upside and downside risks for crude oil prices.

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