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Two Risk Factors Emerging for International Energy Market Destabilization

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With the year 2012 having just started, international energy markets see two emerging risk factors that are characteristically different and could affect markets in the opposite ways. One is the growing tension of the Iranian situation (a geopolitical risk). The other is the European economic crisis (a global economic risk).

Tensions in the Iranian situation began to grow late last year. U.S. President Barack Obama signed the National Defense Authorization Act for Fiscal Year 2012 into law on December 30, prompting the tensions to intensify from the beginning of this year. The act pursues economic sanctions that could effectively work as an embargo on Iranian oil exports through punitive measures against the Central Bank of Iran. In a new development, U.S. Treasury Secretary Timothy Geithner has visited China and Japan as major Iranian crude oil importers to call for their cooperation in the sanctions, indicating tough U.S. diplomacic stance toward Iran.

As some countries could be conditionally exempted from the sanctions under the act, how an Iranian oil embargo could be imposed is still uncertain. Also uncertain is how China, India and European countries would respond to the U.S. request for an Iranian oil embargo in consideration of their respective degrees of dependence on Iranian crude and their respective relations with the United States and Iran. We will have to closely watch future developments in anticipating real effectiveness of the embargo.

Given the importance of Iranian crude oil for the international oil market, however, we can expect that a ban on oil imports from Iran by some U.S.-supporting countries may reduce Iranian oil supply in the international market to tighten the overall supply-demand balance. Other members of the Organization of Petroleum Exporting Countries may increase oil production to make up for the loss of Iranian crude (although Iran could strongly oppose such OPEC production expansion). In such event, a fall in surplus OPEC oil production capacity could be interpreted as a decline in the supply-demand buffer to put upward pressure on oil prices.

A greater factor behind the growing tensions since the beginning of the year is the problem of safe passage through the Straits of Hormuz. Angered by moves for economic sanctions including the oil embargo, Iran has threatened to block the straits. U.S. Defense Secretary Leon Panetta described the possible Hormuz blockade as a “red line” that could not be brushed off, leading the problem to attract attention.

Passing through the Straits of Hormuz are more than 17 million barrels a day in oil (some 20% of global oil supply) and more than 82 million tons in LNG (about 30% of global LNG supply). The Straits of Hormuz is a major artery of energy transportation. Safe passage through the straits is vital to energy security for the entire world.

Some people view Iran as unlikely to implement the Hormuz blockade which could amount to "suicide" for the country. Given the complicated Iranian situation, Israel's possible preemptive attacks on Iranian nuclear facilities and Iran's growing tensions with neighboring countries as well as the United States and Europe, however, no optimism can be justified. If safe oil and LNG passage through the straits is affected for a certain period of time, it may inevitably exert great impacts on energy prices and supply-demand conditions. We now see a great risk for securing stable energy supply for Japan where LNG and oil thermal power generation has grown more important for electricity supply/demand measures.

At the same time, we must pay attention to downside risks for the world economy. The United States has seen improvements in some macroeconomic indicators since the second half of last year, but it has yet to achieve any full-fledged economic recovery. Given the lingering slump in the residential sector, no optimism can be warranted. In Europe that has attracted attention most in the world, Standard & Poor's downgraded sovereign debt ratings for nine major countries on January 14, shaking financial markets in the world.

In the downgrade, France and Austria lost their most creditworthy status with their ratings lowered to AA+ from AAA. Although four countries including Germany and the Netherlands maintained their AAA ratings, the downgrade for France, which constitutes the core of the European economy and is in position to rescue Greece, Italy and others plagued with credit crises, has heightened concerns about a rise in fundraising costs for the European Financial Stabilization Facility and doubts about the credit scheme and its effectiveness.

Regarding the European debt crisis, some people say that the sovereign debt rating downgrade for major European countries had earlier been viewed as possible and factored into the market to some extent. But the development indicates that one of the expected risks regarding the European crisis and countermeasures has actually emerged. We must pay attention to the development's future impacts. We must take note of the possibility that the credit and banking crisis could deteriorate the real European economy further and lead to international financial market destabilization, shrinking international trade with other spillover developments affecting the real world economy. In another development attracting global attention, China's growth of October-December 2011 GDP from a year earlier dropped to a 10-quarter low of 8.9% that has driven the world economy since the Lehman Shock, indicating an economic slowdown more clearly. At the beginning of 2012, the world economy is plagued with a growing number of uncertain factors.

In our institute's International Oil and Gas Situation Outlook for 2012 published late last year, I cited the Iranian situation and the European economic crisis as major factors affecting energy markets. Since the beginning of the year, we have seen simultaneous developments regarding the two factors, indicating a stormy start for the year. While Japan is fundamentally reviewing its energy policy, the international environment and situation surrounding Japan are growing tougher. While watching future developments regarding the risk factors, Japan must promote its energy measures and policy review in consideration of various possibilities and scenarios.

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