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2014 1st-Half International Oil Market and Short-term Prospect for Oil Prices

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Crude oil prices remained high in the first half of 2014. The daily closing levels of the front-month futures price for the benchmark Brent crude oil averaged $108.8/barrel in the six months between the beginning of this year and the end of June. Those for the other benchmark brand of West Texas Intermediate averaged $100.8/barrel. Both averages topped $100/barrel. As the annual average for the Brent futures stood at $111.0/barrel in 2011, $111.7/barrel in 2012 and $108.7/barrel in 2013, the benchmark crude oil price has stayed above $100/barrel on an average basis for three and a half years. Crude oil prices remaining at high levels for such a long time is unusual in the long history of the international oil market.

Crude oil prices in the first half of 2014 featured a narrower fluctuation range, indicating that they remained stable at high levels. For example, Brent moved between $93.3/barrel and $126.7 with a fluctuation range of $33.4/barrel in 2011, between $89.2/barrel and $126.2/barrel with a range of $37.0/barrel in 2012, between $97.7/barrel and $118.9/barrel with a range of $21.2/barrel in 2013, and between $104.8/barrel and $115.1/barrel with a range of $10.3/barrel in the first half of 2014. The Brent price thus remained not only high but also in a narrower range in the January-June period this year.

Why are crude oil prices in such conditions? There may be various factors working behind the conditions. A key point is that various imbalances have offset each other, bringing about a kind of equilibrium. Among supply and demand fundamentals, China and other emerging countries, which had driven global oil demand growth, have decelerated oil demand growth in line with their economic growth slowdown. But the United States has robustly expanded oil demand in line with its economic recovery, offsetting the deceleration of oil demand growth in emerging countries.

On the supply side, crude oil production in major Middle Eastern and North African oil producing countries such as Libya, Syria, Nigeria and Iran decreased by some 1 million barrels per day due to domestic security deterioration, economic sanctions or other factors in 2013. But U.S. oil output increased by about 1.1 million bpd due to a shale oil output expansion, offsetting the production decrease. This trend has continued into this year. Production drops and increases in major oil producing countries have been offsetting each other. Even under such situation, some supply-demand imbalances can emerge. But Saudi Arabia has increased or decreased output as a supply/demand balancer, maintaining balance between supply and demand. In this way, the supply-demand equilibrium has remained in the recent market.

Major oil producing countries see high oil prices as favorable for financing their growing social spending. International oil companies are plagued with rising costs including labor and equipment expenses. High-cost U.S. shale oil producers have increased their presence as marginal oil producers. High oil prices are comfortable for these key international oil market players, excluding Japan and some other countries that depend on imports for most of their oil supply. Such market perception might have influenced oil futures market players' trading sentiment, leading to the present situation where oil prices remain stable at high levels.

Then, whether the current equilibrium will remain or whether some factors will arise to affect the equilibrium would be important for anticipating the international oil market and crude oil prices for the immediate future. In this sense, we must pay attention to the Iraqi situation that has rapidly deteriorated since June in a manner to surprise the world.

Sunni armed rebels, led by the ISIS (Islamic State of Iraq and al-Sham) militia organization, have taken control of key locations including Mosul in northern Iraq, intensifying fighting with Iraqi government forces. Under such situation, a dispute between Sunni and Shiite Muslims has emerged in Iraq, with the Kurd autonomous region taking independent actions. Iraq is seemingly going in the direction of destabilization or breakup instead of stabilization for national unification. As Iraq located between Iran and Saudi Arabia has a geopolitically important position in the Middle East, its domestic destabilization could destabilize the whole of the Middle East through the escalation of religious disputes and ethnic problems. This is the reason crude oil prices began to rise in response to geopolitical risks just after the intensification of tensions in Iraq and hit the half-year period's high above $115/barrel.

At present, however, the destabilization has yet to disrupt or affect major Iraqi oil fields and oil export facilities. Particularly, major Iraqi oil fields are located in the south controlled by Shiites and have been kept away from the destabilization caused by government forces' clash with Sunni rebels. Therefore, crude oil prices have recovered a stability following the temporary hike. But the crude oil price trend could change depending on developments in the Iraqi situation. In this sense, no optimism can be warranted about the Iraqi situation including the stability of the southern oil field region. If the Iraqi situation deteriorates further to increase geopolitical risks or if some developments cause production or export disruptions in the key oil field region, crude oil prices may rise rapidly.

We must also pay attention to the impact of the Iraqi destabilization on market sentiment. Over the past few years, Iraq has steadily expanded oil production with international oil companies' investment. It had been expected to expand oil output substantially over a medium to long term and grow significant for global oil supply if things go well. In a sense, the expectation had been priced into the market. But the latest Iraqi destabilization endangers the future substantial expansion in Iraqi oil production. This point is also significant for anticipating future crude oil prices.

Amid the recent crude oil price hikes, gasoline prices have continued rising in Japan. A weekly survey by the Oil Information Center indicates that the nationwide average retail price of regular gasoline on June 30 rose for the 10th straight week, reaching 168.4 yen per liter close to the 170 yen level. Factors behind the gasoline price hike include not only crude oil price hikes but also the yen's depreciation, the consumption tax increase and petroleum product supply/demand conditions. But crude oil price hikes are a great factor. Depending on future developments, the hikes could affect Japan's national economy and livelihood. Crude oil price hikes can also result in higher prices for imported liquefied natural gas, affecting electricity rates and energy costs. As a matter of course, downside risks for crude oil prices exist, including the Chinese economy's rapid deceleration. In the second half of this year, however, we will have keep close watch on the Iraqi situation and other turbulent factors for the international oil market.

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