Rapidly Falling Crude Oil Prices and Its Background

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

On October 3, the West Texas Intermediate (WTI) crude oil futures price (the daily closing price for the front-month contract) fell by $1.27/barrel from the previous day to $89.74/barrel, the lowest level in 17 months. The futures price for another international benchmark crude oil, Brent, which is believed to reflect the global oil market conditions better than WTI, dropped by $1.11/barrel to $92.31/barrel. On an intraday basis, it hit a 27-month low of $91.48.

The average Brent price for the first nine months of this year remained high above $100/barrel. On a daily basis, however, the Brent price turned down after peaking at around $116/barrel in response to growing geopolitical risks regarding the destabilization of the Iraqi situation in June. It has plunged some 20% since then. The price slipped below $100/barrel on September 8 and has accelerated its decline since then. Whether the Brent price as well as the WTI price would drop below $90/barrel is attracting global attention.

Behind the crude oil price drop have been several different factors that are interacting with each other. The first factor is the disappearance of the influence of the geopolitical risks in the oil market. Triggering the price hike in June were growing geopolitical risks regarding the Iraqi situation as noted above. The Iraqi situation has remained tense as the United States, the United Kingdom, France and five Middle Eastern countries have enhanced bombings on ISIL (Islamic State in Iraq and the Levant) rebels in Iraq and Syria. But the Iraqi tensions so far have fallen short of disrupting Iraqi oil supply so seriously. Although the tense situation is expected to affect a medium to long-term oil output expansion, the relationship between geopolitical risks and oil supply disruptions has weakened, with the market losing its sensitivity to the risks. While supply and demand changes have exerted downward pressure on crude oil prices, the past rise attributable to the geopolitical risks is being offset. In this respect, a key point from now on is whether geopolitical risks would trigger oil supply disruptions in an unanticipated manner.
The second factor is the easing oil supply-demand balance that has exerted great downward pressure on oil prices. The market has paid attention to China's oil demand growth that has weakened on an economic slowdown after driving a global oil demand rise in the last several years. China seemed to achieve an annualized economic growth rate of around 7.5% in the April-June quarter thanks to some economy-boosting measures by the Chinese government that has grown concerned over an economic slowdown. But the future course of the Chinese economy remains uncertain, with various economic concerns including housing prices sustaining a downward trend. In addition, the European economic slump has become a serious matter of concern, with deflation fears growing. Under the circumstances, global oil demand growth has slackened, prompting demand growth projections to be revised downward.

On the other hand, overall oil supply has continued a steady expansion. Market supply is abundant. It may be needless to say that the supply growth is primarily attributable to the ongoing U.S. shale boom. U.S. oil production growth in three years from 2012 exceeded 3 million barrels per day. The U.S. Department of Commerce decided in June to approve the export of partially processed condensate, indicating that the U.S. oil output expansion would exert a major direct impact on the international market. The impact of the recent increase in Libyan output is also visible. Libyan oil output has fluctuated widely since 2011. Libyan oil production totaled 1.5-1.6 million bpd before the collapse of the Muammar Gaddafi regime and was totally suspended amid a civil war. After recovering the past level more rapidly than expected following the regime change, oil production declined substantially again due to the deterioration of the domestic situation and security last year. Even after early this year, Libyan oil output changed widely. Since September, the output has recovered more rapidly than expected again, exerting supply pressure particularly on the European market. The easing supply-demand balance amid expanding supply and weakening demand has been combined with the dropout of geopolitical risks from the market to promote a decline in crude oil prices.

The third factor is the dollar's appreciation whose impact cannot be shrugged off. Many market participants have pointed out that U.S. monetary policy developments and the dollar's appreciation have contributed to the recent crude oil price drop. Some relations have sporadically been seen between the dollar's value and crude oil prices. This may be because (1) buy or sell pressure emerges on crude oil priced in dollars when the dollar is viewed as overvalued or undervalued and (2) the dollar's appreciation or depreciation affects the selection of oil as a real asset alternative to the dollar. The present appreciation of the dollar has been viewed as actually contributing to the crude oil price weakness.
In this way, crude oil prices have been falling as various factors have interacted with each other. Therefore, the future course of crude oil prices is attracting attention. A focus of attention is whether the Brent price as well as the WTI price could slip below $90/barrel. If the present trend continues, the market is likely to test the decline below the level. If the price falls below $90/barrel, the next focus of attention will be whether the Organization of the Petroleum Exporting Countries could cut production. On the U.S. crude oil output expansion as a key factor working to ease the oil supply-demand balance at present, some sources in Saudi Arabia recently stated the Brent price would not slip below $90/barrel due to high production costs for shale oil that holds the key to the U.S. output expansion. Even if the price slipped below the level, it might be a temporary phenomenon, it noted. This Saudi view is reasonable in a sense. But any price hike or fall can overshoot, as indicated by history. If the supply-demand balance eases further with crude oil prices falling within this year, OPEC's response may be the greatest focus of attention. In this sense, future market developments will attract much attention.

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