Special Bulletin

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# Crude Oil Prices Plunge Rapidly with WTI Slipping below $80

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Crude oil prices are falling rapidly. On October 16, the West Texas Intermediate crude oil futures price (for the front-month contract) slipped below $80/barrel for the first time in about 28 months, since late June 2012, briefly hitting a low of $79.78/barrel. Although the day's closing price gained $0.82/barrel from the previous day to $82.70/barrel, the decline in crude oil prices has accelerated since early October. What we see now could be described as a plunge. The futures price for another international benchmark crude oil, Brent, has also fallen sharply. On October 16, the Brent price dived to a four-year low below $83/barrel, before closing slightly higher at $84.47/barrel.

As noted in “A Japanese Perspective on the International Energy Landscape (189),” crude oil prices entered a downward trend in September. After dropping below $100/barrel in September, the WTI price slipped below $90/barrel on October 3 in a continuous decline. This time, the WTI futures declined below $80/barrel, though temporarily. Market players are paying attention to how far the WTI and Brent prices would drop toward the $70/barrel level.

Multiple factors have been combined to cause the downward trend for crude oil prices (as noted in the earlier report). Key factors among them are fading concerns on oil supply interruptions resulting from geopolitical risks like the unstable Iraqi situation, a global oil demand slowdown and downward revisions to oil demand forecasts amid global economic slump fears, the continued expansion of global oil supply through the sustained rise in U.S. shale oil production and a Libyan oil production recovery, the resulting easier supply-demand balance in the international oil market, and the rising dollar's downward pressure on crude oil prices. However, new factors emerged this week to exert strong downward pressure on crude oil prices.

The new factors are global economic turmoil and a growing sense of insecurity about the future, as symbolized by the recent global stock market decline. The Dow Jones industrial average on the New York Stock Exchange plunged from the year's closing high of 17,279 on September 19 to 16,074 on October 16. The stock market decline has not been limited to the United States. Japan's Nikkei stock average on October 16 posted a 10% plunge from this year's high. The German stock market logged a 14% dive, symbolizing the recent European economic slump. As China, India and other emerging economies have slowed down with downside risks seen after driving the world economy and there has been a growing sense of insecurity about the future European economy, the United States has been expected to drive the world economy. Under such situation, markets have tended to overly react to any economic indicators that add to insecurity about the future U.S. economy. Some analysts have noted that Ebola epidemic fears, though having little connection with market fundamentals, have contributed to market turmoil.

Also behind the oil and stock market plunge has been the U.S. Federal Reserve's decision to end its third quantitative easing after confirming an economic recovery. As massive liquidity provided throughout the world through quantitative easing is being rolled back due to the decision, the emergence and growth of various economic risks are apparently leading funds to shift from high-risk assets to lower-risk assets. In this sense, funds might have been shifting from crude oil and other commodity markets as well as stock markets to U.S. Treasury and gold markets, trigging the sharp falls in stock and crude oil prices.

Given the above, how far crude oil prices will decline depends first on when the global economic insecurity or turmoil will end. At present, I have no choice but to say that the future is too uncertain. Some analysts say the U.S. economy as a driver of the global economy is firm and will steadily recover or expand, leading to a market rebound. But we cannot brush off downside risks for the United States and the world economy. In this sense, I expect that crude oil prices will fluctuate as the world economy seesaws through late this year or early next year. If the market weakens, crude oil prices may slip below $75/barrel (or $70/barrel depending on some developments).

Second, how far crude oil prices will fall depends on what Saudi Arabia will do. Saudi Arabia has so far seemed to have maintained its basic stance of leaving the market to determine crude oil prices without resorting to any substantial production cut. At a time when crude oil prices have actually fallen below $90/barrel and are likely to further decline, however, Saudi Arabia may be required to consider what to do next. Present crude oil prices are below the level (about $90/barrel) required to balance its budget. In this sense, Saudi Arabia has a motive to reverse the price trend. At the same time, however, Saudi Arabia has had a budget buffer accumulated through massive oil revenues in the past, remaining able to tolerate low crude oil prices over a certain period of time. Saudi Arabia may have to strategically consider (1) what implications the low crude oil prices would have for the world economy, (2) how the low crude oil prices would affect the international oil market for Saudi Arabia and its potential rivals (including U.S. shale oil production, Iran, Iraq and Russia) from the geopolitical viewpoint, and (3) how the low crude oil prices would affect Saudi Arabia's relations with the United States that holds the key to security for the oil kingdom.

As many factors of the future are thus uncertain, the international oil market is expected to remain unstable while testing lower ground than the present levels in the immediate future. We will thus have to closely watch world economy fundamentals, international financial market trends, geopolitical risks and Saudi policy developments.

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