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Washington to Launch Full Oil Embargo on Iran without Extending Waivers

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On April 22, the U.S. State Department announced to end waivers on May 1 on its Iran oil embargo for Japan, China, India, South Korea, Taiwan, Italy, Greece and Turkey, paving the way for companies in the eight economies to become subject to U.S. economic sanctions if they import Iranian crude oil.

The U.S. Trump administration in May 2018 offered to unilaterally withdraw the United States from an international Iran nuclear deal cut under the previous Obama administration, reviving U.S. economic sanctions on Iran. As Iran's oil exports vital to its economy became subject to the sanctions, the fate of Iranian oil exports attracted attention as a key factor affecting oil prices. In November 2018, however, Washington announced the 180-day waivers for the eight economies. As the waivers' expiration in early May approached, how Washington would treat the waivers attracted global attention. Then, the announcement to end the waivers came, indicating a U.S. policy of a full oil embargo on Iran.

Crude oil futures prices rose in response to the announcement. On April 22, the closing price of the front-month futures contract rose by $1.70 per barrel to $65.70/bbl for West Texas Intermediate on the New York market and by $2.07/bbl to $74.04/bbl for Brent on the London market. These prices represented their year-to-date highs. On April 23, WTI and Brent rose further, rewriting their respective year-to-date highs to $66.30/bbl and $74.51/bbl. Crude oil prices have risen back from their bottom levels late last year thanks to a joint oil production cut by the Organization of the Petroleum Exporting Countries and some non-OPEC oil producing countries from the beginning of the year, Saudi Arabia's heavy production cut and declining oil production in Venezuela plagued with social and economic confusion. Brent rose back above $70/bbl for the first time in five months earlier in April. In such environment, the market responded sensitively to the U.S. decision on the full Iran oil embargo.

Behind the decision to end the waivers, the United States has basically retained a tough stance against Iran over the past one year since vowing to withdraw from the Iran nuclear deal, while exceptionally admitting the temporary waivers on the sanctions. One year after the withdrawal announcement, Washington has eventually renewed its tough stance against Iran. When the temporary waivers were given last November, however, there was speculation that the Trump administration would be willing to avoid gasoline price hikes that could result from crude oil price increases to be caused by a tighter supply-demand balance amid the tough Iran oil embargo ahead of the next U.S. presidential election in 2020. Therefore, a U.S. decision on the waivers following the recent oil price hikes attracted global attention. The decision to implement the full Iran oil embargo came as crude oil and gasoline prices were well expected to rise.

In this sense, the Trump administration might have apparently considered the present crude oil prices, including about $65/bbl for WTI, and current gasoline prices (slightly less than $3/gallon on a U.S. average basis for regular gasoline) as tolerable. Ahead of the presidential election, President Donald Trump apparently hopes to avoid gasoline price hikes. As far as current price levels are tolerable, however, the Trump administration might have concluded that any further crude oil price hike may be countered by production and supply expansion to stabilize the supply-demand balance.

The market has responded to the U.S. decision to implement the full Iran oil embargo because Iran is an important oil exporter and holds the key to the Middle Eastern geopolitical situation. According to the International Energy Agency, Iran's crude oil and condensate exports in March stood at about 1.4 million barrels per day. Iran has gradually reduced crude oil exports from abound 2.5 million bpd before the sanctions. The decline has continued even during the waiver period. Secretary of State Mike Pompeo vowed to cut Iranian crude oil exports to zero. Attracting global attention in the future will be the extent to which Iranian oil importers would cut purchases. Irrespective of whether Iranian oil exports could be cut to zero, the Iranian exports are well expected to decline substantially. The next problem is who would cover the Iranian oil export decline.

Then, the next step of the OPEC-plus group is attracting attention. Particularly, its leader Saudi Arabia's action has become subject to close watch. The OPEC-plus group, including Saudi Arabia, has reduced production far more than indicated by the target of 1.2 million bpd since the beginning of the year. If crude oil prices rise further, President Trump may single out the coordinated OPEC-plus production cut for condemnation. Then, he may directly urge the group's leader Saudi Arabia to increase oil production to stabilize the supply-demand balance.

Saudi Arabia has enough capacity to increase production. Due to the oil production cut since the beginning of the year, Saudi Arabia's production in March sank to 9.82 million bpd, the lowest since early 2017. Given that its production exceeded 11 million bpd last November, Saudi Arabia can be expected to expand production by more than 1 million bpd. Based on the March production level, the IEA estimates Saudi Arabia's surplus production capacity at 2.2 million bpd. In this sense, Saudi Arabia is best expected and prepared to cover a large decline in Iranian oil exports.

As a Middle Eastern U.S. ally that heavily depends on the United States for its national security, Saudi Arabia has no choice but to appropriately respond to President Trump's possible request for expanding oil production. The Trump administration has given priority to the United States' relationship with Saudi Arabia even while the oil kingdom has come under fire for the Khashoggi scandal since last year. In this sense, the Trump administration has grown more significant for Saudi Arabia. In addition to the Iran problem, Venezuela's falling oil production and Libya's destabilization have emerged as supply reduction risks in the international oil market. Saudi Arabia will be increasingly expected to address these risks as well.

In such situation, Saudi Arabia could avoid any tighter supply-demand balance on a calculation or flow basis by increasing oil production substantially to cover a decline in Iranian oil exports. However, the problem is that a substantial increase in Saudi Arabian oil production would result in a drop in its surplus production capacity, leading the world to lose a cushion for stabilizing global oil supply and demand. Furthermore, the Iranian situation could grow more tense due to the substantial drop in oil exports, heightening geopolitical risks in the Middle East. In this way, high geopolitical risks in the Middle East could coexist with a decline in the supply cushion. How market participants would view such potential development would exert influence on future crude oil prices. As a matter of course, market players are closely watching the fate of the U.S.-China trade war, global economic risks, U.S. shale oil production expansion and other factors. In the wake of the U.S. decision to implement the full Iran oil embargo, however, the Iran problem and geopolitical risks could come back as a central matter of concern in the international oil market. I would like to closely watch relevant future developments.

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