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Great Oil Price Uncertainties despite Rally on Potential Production Cuts

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On April 2, crude oil futures staged a steep rally. The front-month West Texas Intermediate futures contract closed at $25.32 per barrel, up $5.01/bbl or about 25% from the previous day. The front-month Brent futures contract also scored a steep gain of $5.20/bbl or about 21% to $29.94/bbl. The sharp rally, though leaving oil prices still below $30/bbl, has attracted attention from market participants as a dramatic change.

Behind the steep rally are hopes that oil-producing countries would reconstruct their joint production cut initiative that has collapsed. Triggering the hopes was U.S. President Donald Trump's Twitter message that he expected Saudi Arabia and Russia now in a price war to cut oil production by about 10-15 million barrels per day. The message came after his telephone talks with Saudi Crown Prince Mohammed bin Salman and Russian President Vladimir Putin and triggered the hopes on joint production cuts.

Furthermore, reports say that Saudi Arabia has proposed that the Organization of the Petroleum Exporting Countries and non-OPEC oil producing countries including Russia hold an emergency meeting to discuss how best to stabilize the oil market in response to an oil price crash that has come as global economy risks have grown serious on the expansion of the new coronavirus disease known as COVID-19. Future OPEC-plus talks will thus attract great attention.

Crude oil prices plunged into a free fall in March. At a time when the international oil market was in oversupply due to growing U.S. shale oil production, a global economic slowdown and city lockdown amid the expanding COVID-19 pandemic sharply reduced oil demand and boosted oversupply further. Accelerating the oil price downturn was the collapse of the OPEC-plus joint production cut initiative and a subsequent race to expand production in a price war.

During the free fall, the key WTI futures price suffered a sharp daily fall of more than $10/bbl to $31.13/bbl on March 9 following the collapse of the joint production cut initiative on the previous trading day. Furthermore, WTI slipped below $30/bbl amid the expansion of the COVID-19 pandemic, hitting a low of $20.09 on March 30. Market participants then were concerned that the price would decline below $20/bbl or post an even steeper fall and remain weak over a long term if the price war continues, with the pandemic worsening.

While governments in the world are making desperate efforts to stabilize the situation regarding the COVID-19 pandemic, no path to the end of the pandemic has come into sight. The pandemic is likely to keep downward pressure on oil prices over a long time. Theoretically, one of the biggest factors to support or boost oil prices amid such situation is the reconstruction of the OPEC-plus joint production cut initiative. This is the reason the oil market reacted to President Trump's Twitter message and the proposal for OPEC-plus talks.

As noted in the 471st issue of A Japanese Perspective on the International Energy Landscape, Saudi Arabia might have intended to tolerate sharp oil price falls once and lead the negative effects of weak oil prices to be shared among oil-producing countries anew before reconstructing the collapsed joint production cut initiative. Oil prices' plunge to the brink of falling below $20/bbl might have led oil-producing countries to become concerned about oil prices' further deterioration, bringing about the latest developments.

Interestingly, the United States is among oil-producing countries that shared the strongest pains of falling oil prices. Unlike Saudi Arabia or Russia, the United States does not depend on oil revenue for national finance. It does not have to consider keeping oil prices at certain levels to balance its national budget. As shale oil production or shale revolution progress has supported U.S. prosperity and national power expansion until recently, however, the oil price crash amid the COVID-19 pandemic came as a strong pain for the United States, particularly the Trump administration. The oil price plunge has hard hit the U.S. oil and gas industry, leading some shale companies to fail. Oil prices' fall induces a gasoline price decline that is politically and economically positive for the United States. Now that the oil price crash has seriously affected the oil and gas industry having contributed much to U.S. economic prosperity and national power expansion and invited a stock market crash, however, President Trump might have acknowledged that the current situation is unignorable.

For Saudi Arabia, U.S. shale oil is a strong rival from the viewpoint of international oil supply and demand. Shale oil production expansion forces Saudi Arabia to cut production and lose its market share. If an oil price crash works to cap growth in high-cost U.S. shale oil production, it would be favorable for Saudi Arabia. However, it is difficult for Saudi Arabia or its Crown Prince Mohammed bin Salman to turn down a strong request from President Trump. This is because the United States is the most important superpower for Saudi Arabia's national security and President Trump has supported and maintained close, good relations with Crown Prince Mohammed bin Salman.

Attracting attention next would be Russia's response. Russia's refusal to enhance the OPEC-plus joint production cuts has triggered the collapse of the joint production cut initiative. The refusal is apparently based on a strategic recognition that the enhanced production cuts would eventually benefit high-cost U.S. shale oil production to the disadvantage of Russia. It is uncertain whether Russia would come back to the joint production cut initiative in response to President Trump's request. As far as skepticism and uncertainties remain about Russia's comeback to the initiative, oil prices may remain unstable.

When Russia rejected the enhanced joint production cuts and walked out of the OPEC-plus meeting on March 6, it indicated that it was more resistant to low oil prices than Saudi Araba. Russia has assumed that oil prices around $40/bbl would be required to balance its 2020 budget, slipping far below more than $80/bbl as assumed for Saudi Arabia. Some analysts pointed out that Russia would resist weaker oil prices by dipping into funds accumulated when oil prices were high. However, I think that the reality surrounding Russia is no longer favorable. Oil prices have slipped below $30/bbl, indicating that the Russian budget would fall far short of being balanced and that Russia's economic growth would be seriously affected. Europe, a major oil and gas export destination for Russia, has been seriously hurt by the COVID-19 pandemic, dealing a severe blow to Russia. Furthermore, Western economic sanctions have made international fundraising more difficult for Russia than for Saudi Arabia. The latest oil price crash has thus been very painful for Russia as well, requiring Moscow to seriously consider countermeasures.

We will have to closely watch future bargaining among the United States, Russia and Saudi

Arabia as the world's three biggest oil producers regarding not only their influence on the international oil market supply-demand balance but also international relations and geopolitical issues.

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