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Summary

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**Recent International Political/Economic Situation and Oil Price Trends
- Keynote Speech: Background Factors of the Recent Steep Rise in Oil Price and
Future Prospects -**

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<Research Objective>

The oil price soared in the international market: on June 1, 2004, the (near-term) futures price for the WTI, world benchmark crude oil price, rose to \$42.33 per barrel, reaching a record high (see Fig. 1). The average WTI price for the period from January to May 2004 also stayed at a high level of \$36.5.

In the past, the steep rise in oil price occurred mostly in the event of disruption to oil supply, such as the first and second oil crises, the Gulf War, and the Iraqi War, etc. This time however, the oil price has soared above \$40 despite the absence of any particular disruption of oil supply.

There is concern that the current steep rise in the oil price could have an adverse impact on the world economy that is currently on the road to recovery and expansion. Furthermore, the trends in the international oil situation and oil price are major factors that have a significant influence on the future of the world energy market and energy supply and demand.

Based on the above recognition, this report analyzes the background factors of the recent steep rise in the oil price and then presents future prospects of the international oil situation and oil price.

<Major Conclusions>

1. There are four major factors influencing the recent steep rise in the oil price: (1) tightening supply and demand situation in the international oil market; (2) tightening supply and demand of gasoline in the United States; (3) unstable situation in the Middle East; (4) impact of speculative transactions in the oil futures market. As a result of the combination of these factors affecting and influencing one another, the oil price has soared, despite the absence of disruption of oil supply.

2. The decline in the spare supply capacity and the buffering function for adjusting the supply-demand balance has become obvious in the international oil market. The spare supply capacity consists of OPEC's spare oil production capacity, oil stock and inventory, and the (excess) oil refining capacity, each of which has decreased due to the increase in demand and the efforts of oil companies streamlining and cost reduction. Because of the decline in the spare supply capacity and the buffering function for adjusting the supply-demand balance, a pattern has emerged in which the oil price is likely to fluctuate (soar) significantly depending on changes (or speculations of changes) in supply and demand.

3. At the 131st meeting, OPEC decided to raise the production ceiling by 2 million B/D in July and additionally by 0.5 million B/D in August. OPEC's raising of the production ceiling is basically an important factor that may stabilize (lower) the oil price. However, considering that the current steep rise in the oil price has been caused by a combination of various factors, the effectiveness of OPEC production increase is called into question, it is difficult to predict whether the OPEC's current decision alone can bring about the stabilization and a sharp drop in the oil price.

4. Taking the above mentioned supply-demand factors and risk factors in the Middle East into account, the WTI oil price is likely to remain around the range of \$35-40 for the time being. As the oil price is expected to continue fluctuating significantly in the future, it might easily go beyond or below this range by about \$3. In particular, in the event of disruption of oil supply due to terrorist attacks in major oil producing countries such as Saudi Arabia, it cannot be denied that the oil price could go far beyond \$40.

<Supplementary explanation>

(1) World oil demand continues to grow vigorously, mainly in China and the United States (see Fig. 2). According to the International Energy Agency (IEA), in 2004, world oil demand will reach 81.08 million B/D, up 2.31 million B/D (2.9%) over the previous year. In particular, demand growth in China is projected to be 0.79 million B/D, accounting for 34% of the world total. In response to such a sharp increase in oil demand, both non-OPEC countries and OPEC countries increased oil production. According to the IEA data, as of May 2004, OPEC's spare capacity of oil production (world's spare supply capacity) has declined to 2.33 million B/D (1.66 million B/D, excluding Iraq), most of which is concentrated in Saudi Arabia (see Table 1).

(2) In the United States, gasoline consumption is growing strongly due to economic recovery and increase in gasoline demand for driving. On the other hand, on the supply side, domestic refineries are being operated almost at full capacity, resulting in the shortage of extra production capacity for gasoline. Furthermore, gasoline supply is being disturbed due to the tightened regulations on gasoline quality and the gap in such regulations among states, which prevents flexible supply allocation/distribution. For these reasons, the gasoline price has soared in the United States,

exceeding \$2 per gallon (see Fig. 3). This steep rise in the US gasoline price is an important factor that has driven up the oil price.

(3) Under such circumstances, the unstable situation in the Middle East has become an issue of concern for market participants and has accelerated the price rise. In particular, two incidents of terrorist attacks that occurred in May at oil facilities in Saudi Arabia, which is the world's largest oil producing country and has the world's largest spare capacity of oil production (spare supply capacity in an emergency), have seriously affected market sentiments. Although in reality, these incidents had no impact on Saudi Arabia's oil production and export capability, they have affected business sentiments in the futures market as a destabilizing factor in the future and brought about the steep rise in the oil price.

(4) Amid the tightening supply and demand situation and the unstable situation in the Middle East, a large amount of speculative funds seem to be flowing into the oil futures market. In the NYMEX oil futures trading, the long position of non-commercials (funds and general investors) has increased significantly, reaching a record high and showing an obvious movement linked to oil price trends (see Fig. 4). Under such circumstances, the current high oil price contains a large amount of "premiums" arising from speculation caused by the unstable situation in the Middle East and the inflow of speculative funds. It is pointed out that the amount of premiums (the gap from the level based on supply and demand fundamentals) has reached \$5-10, though it is impossible to measure the amount precisely in terms of quantity.

(5) At the 131st meeting held on June 3, 2004, in Beirut, OPEC decided to raise the production ceiling by 2 million B/D on July 1 and additionally by 0.5 million B/D on August 1. This decision is OPEC's declaration of its commitment to market stabilization. Basically, OPEC's production increase (increase in the production ceiling) is an important factor that could contribute to market stabilization.

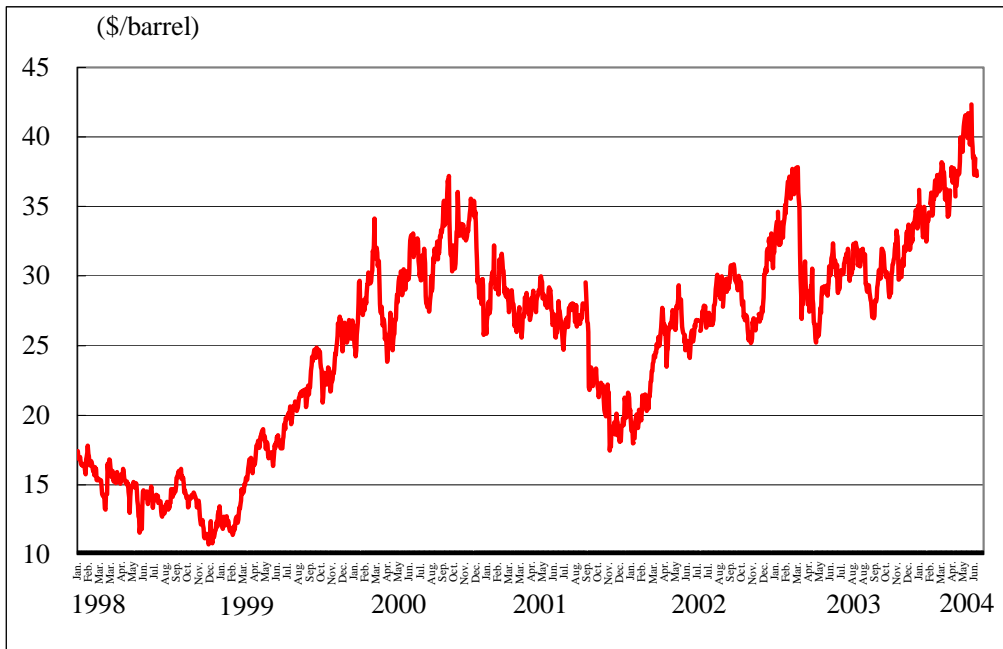
(6) However, as the actual amount of OPEC production has already exceeded the current production ceiling (23.5 million B/D) by about 2.6 million B/D, this decision to raise the production ceiling is nothing but a confirmation of the current excess over production ceiling. Furthermore, most oil from OPEC's production increase is heavy crude oil, rather than light crude oil suitable for increasing production of gasoline that is currently needed in the market. Because of these factors, the effectiveness of OPEC's decision is called into question. In addition, considering that the current steep rise in oil price has been caused by the combination of various factors such as stringent supply and demand of gasoline in the United States and the unstable situation in the Middle East, it is difficult to predict the future oil price trends.

(7) Since the OPEC meeting, the oil price has been declining, the WTI price falling to \$37 as of June 9, but it still remains at a high level. Taking into account the above mentioned supply-demand factors and risk factors in the Middle East, the WTI oil price is likely to fluctuate around the range of

\$35-40 for the time being. Currently, the oil price is very likely to fluctuate significantly (highly volatile), and therefore there is sufficient possibility that the oil price could go beyond or below the range by \$3 (or maybe more). In particular, in the event of (a fear of) disruption of oil supply due to terrorist attacks at oil facilities in major oil producing countries such as Saudi Arabia and Iraq, it cannot be denied that the oil price could further soar and go far beyond \$40. If, on the contrary, (a fear of) disruption of oil supply does not occur and oil supply can get through a summer with high gasoline demand in the United States, the oil price might decline sharply. For the time being though, the situation in the Middle East and the trends in the US gasoline market will continue to affect oil price trends.

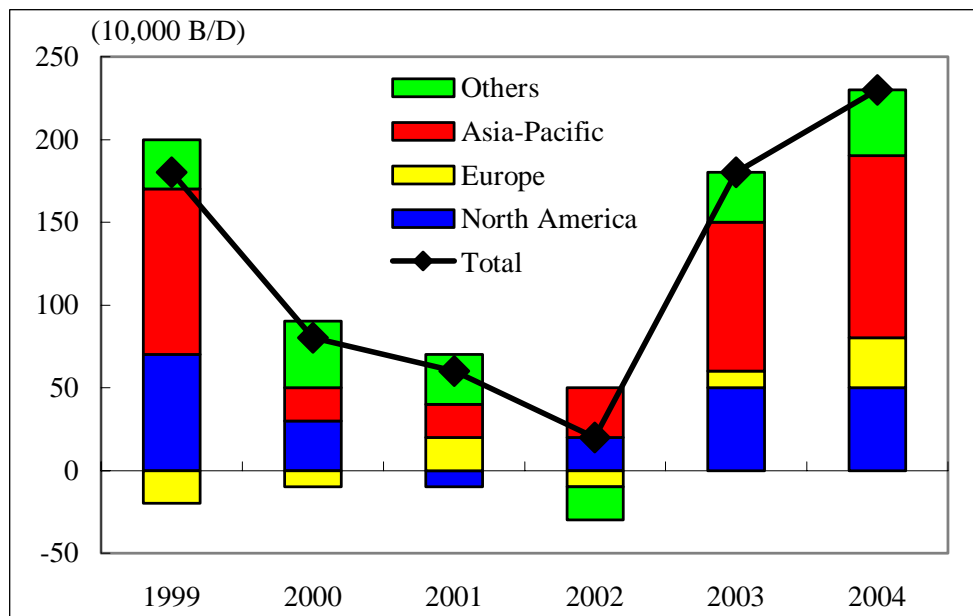
<References>

<Fig. 1> Trends in the WTI oil futures price (NYMEX)



Source: Drawn by the author based on the NYMEX data

<Fig. 2> Trends in the world oil demand growth



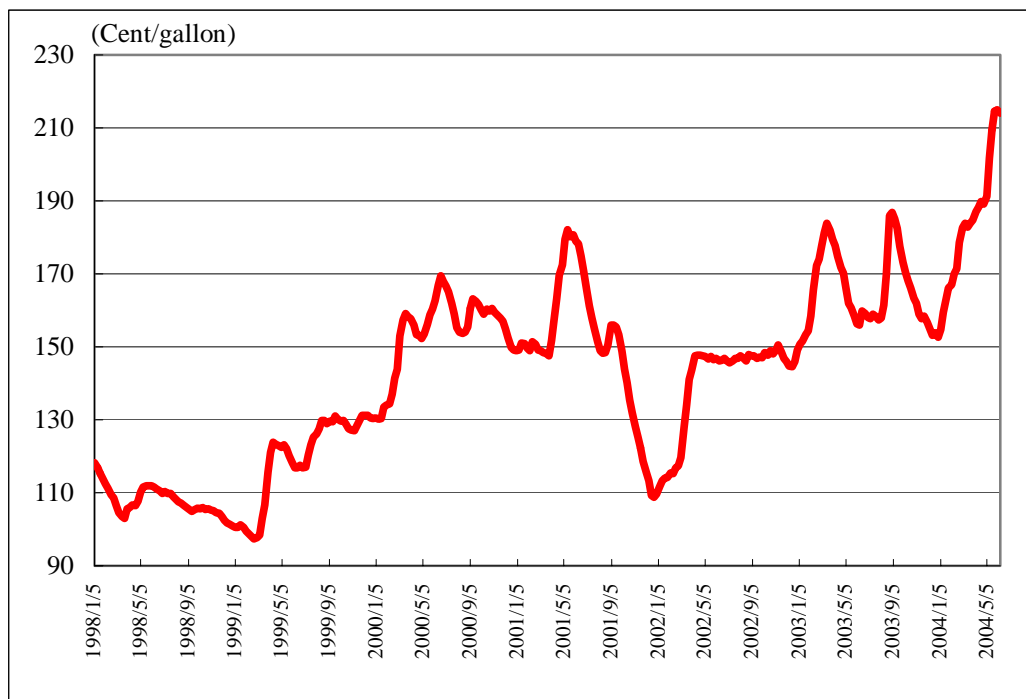
Source: Drawn by the author based on the IEA, Oil Market Report

<Table 1> OPEC oil production and excess capacity as of May 2004

	Capacity of oil production (1,000 B/D) [A]	Production in May 2004 (1,000 B/D) [B]	Excess capacity (1,000 B/D) [A-B]	Current production ceiling (1,000 B/D) [C]	New production ceiling (July) (1,000 B/D)	Excess in production (1,000 B/D) [B-C]
Algeria	1,250	1,180	70	750	810	430
Indonesia	1,000	970	30	1,220	1,320	(250)
Iran	4,000	4,000	0	3,450	3,740	550
Iraq	2,800	2,130	670			
Kuwait	2,300	2,300	0	1,890	2,050	410
Libya	1,550	1,510	40	1,260	1,370	250
Nigeria	2,550	2,330	220	1,940	2,100	390
Qatar	850	790	60	610	660	180
Saudi Arabia	9,500	8,650	850	7,640	8,290	1,010
UAE	2,450	2,250	200	2,050	2,230	200
Venezuela	2,350	2,170	180	2,700	2,930	(530)
Total	30,600	28,270	2,330	23,500	25,500	2,640
OPEC 10 (except Iraq)	27,800	26,140	1,660			
OPEC 9 (except Iraq and Venezuela)	25,450	23,970	1,480			

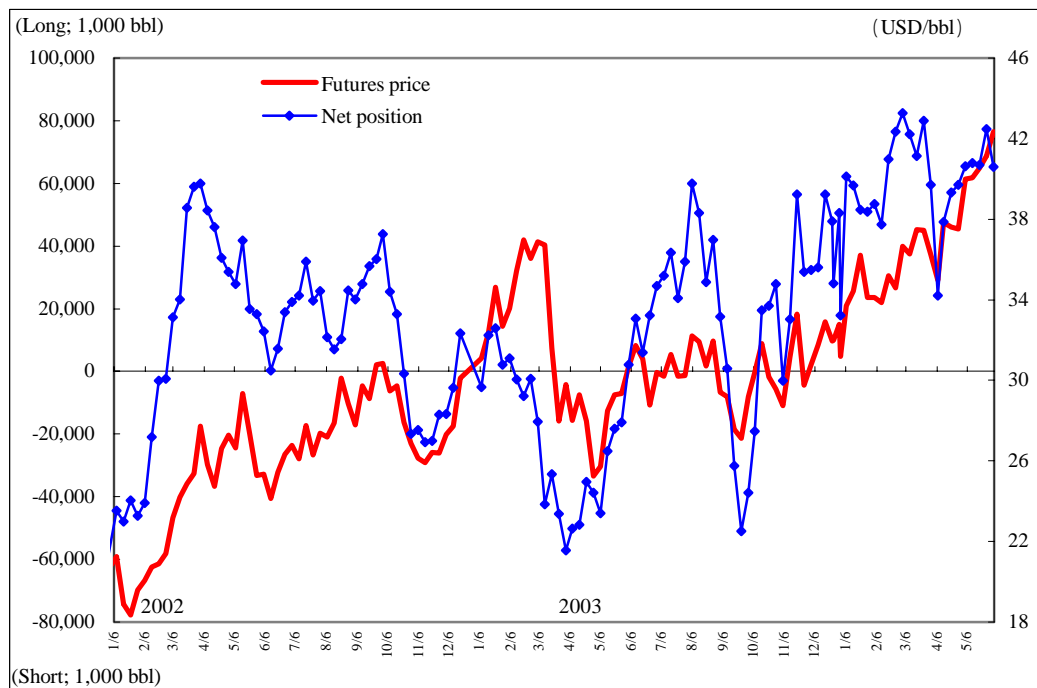
Source: Drawn by the author based on the IEA data

<Fig. 3> Trends in the gasoline retail price in the United States



Source: Drawn by the author based on the data from U.S. DOE/EIA Website

<Fig. 4> Trends non-commercial net trading position for WIT and in the WTI futures price



Source: Drawn by the author based on the NYMEX data and CFTC data

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