Ferguson: Energy Matters

August 17, 2007

PetroDollar Welfare?

I've been reading a provocative book about oil, Iraq and the future of the dollar. In the book, *PetroDollar Warfare,* author William R. Clark has a lot of gripes about U.S. politics and policies, many of which I share. We also share a belief that oil and Iraq threaten the U.S. currency, so I wanted to see what he had to say.

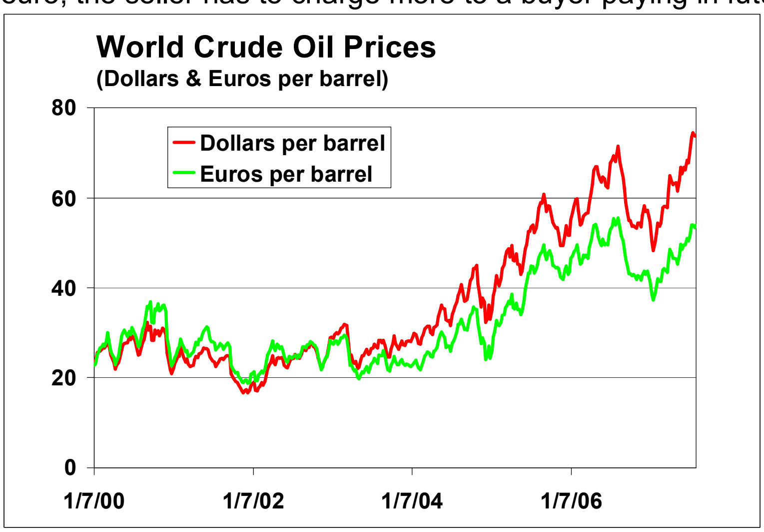
Currently, world benchmark oil prices are established in New York and London markets in dollars. Clark's premise is that trading oil in euros instead of dollars could destroy the U.S. currency and we are on the brink of petrodollar war.

Some theorize that former Iraq president Saddam Hussein's decision to sell Iraqi oil for euros rather than dollars was the real reason the U.S. took him out. Continuing in the same vein, Iranian efforts to establish a new international oil market trading in euros is the real reason the U.S. is now rattling its sabers. Given the current crop of foolish politicians, none of this surprises me. But, we have no way of knowing one way or the other.

The book did get me to thinking, however, about why a Middle Eastern country might want to sell oil for euros rather than dollars. Countries in the Middle East buy a lot more stuff from Europe than they do from the U.S. But international currency markets are quite liquid, with large amounts of dollars and euros exchanged every day. If Iran wants euros, a U.S. buyer can exchange dollars for euros any day.

What's the problem?

The problem arises with deals in which a price in dollars is agreed to for oil to be delivered in the future. A seller needing euros but getting paid in dollars next year has to worry about what the rate of exchange will be then. If the dollar continues to fall against the euro, the seller has to charge more to a buyer paying in future dollars.



As you can see from the chart, oil prices in dollars have increased much faster than the euro prices because the dollar has been losing value relative to the euro. In 2000, a euro would have cost you about a dollar even. Yesterday, it would have cost you $1.3558 according to my newspaper.

Thus, currency risk is a genuine concern for an exporter needing euros. Setting the price in euros is a solid hedge, but there are lots of other hedging instruments. Major international traders surely have a squadron of people whose job it is to minimize currency risk.

A more serious concern is the likelihood that a widespread switch from dollars to euros (or any other currency) for oil trading would reduce the value of a dollar further. One of the major uses for dollars is to buy oil. If oil could be purchased with euros, countries wouldn't need as many dollars and the reduced demand would drive down the value.

I expect that's this nation's chief concern about oil trading in euros.

PetroDollar Warfare would have us believe that the Middle East is on the verge of destroying the U.S. by charging euros for its oil, but that seems far fetched. The U.S. is busy destroying its own currency by printing dollars to cover its budget and trade deficits.

Many countries now have wads of dollars in their foreign reserves, and they aren't suddenly going to destroy the value of those dollars any time soon. This thought provides little solace for the long term, however. Even a slowly eroding dollar puts upward pressure on oil prices which exacerbates the already problematical U.S. trade deficit which further erodes the dollar, which…

—Dr. Rich Ferguson, Research Director, CEERT, rich@ceert.org

The CRETI mission statement discussed in Dr. Ferguson's column two weeks ago has temporarily been withdrawn from circulation pending further revisions. Apologies for any inconvenience this may have caused.