Oil, Currency and the War in Iraq

By Cóilín Nunan

It will not come as news to anyone that the US dominates the world economically and militarily. But the exact mechanisms by which American hegemony has been established and maintained are perhaps less well understood than they might be. One tool used to great effect has been the dollar, but its efficacy has recently been under threat since Europe introduced the euro.

The dollar is the de facto world reserve currency: the US currency accounts for approximately two thirds of all official exchange reserves. More than four-fifths of all foreign exchange transactions and half of all world exports are denominated in dollars. In addition, all IMF loans are denominated in dollars.

But the more dollars there are circulating outside the US, or invested by foreign owners in American assets, the more the rest of the world has had to provide the US with goods and services in exchange for these dollars. The dollars cost the US next to nothing to produce, so the fact that the world uses the currency in this way means that the US is importing vast quantities of goods and services virtually for free.

Since so many foreign-owned dollars are not spent on American goods and services, the US is able to run a huge trade deficit year after year without apparently any major economic consequences. The most recently published figures, for example, show that in November of last year US imports were worth 48% more than US exports[1]. No other country can run such a large trade deficit with impunity. The financial media tell us the US is acting as the 'consumer of last resort' and the implication is that we should be thankful, but a more enlightening description of this state of affairs would be to say that it is getting a massive interest-free loan from the rest of the world.

While the US' position may seem inviolable, one should remember that the more you have, the more you have to lose. And recently there have been signs of how, for the first time in a long time, the US may be beginning to lose.

One of the stated economic objectives, and perhaps the primary objective, when setting up the euro was to turn it into a reserve currency to challenge the dollar so that Europe too could get something for nothing.

This however would be a disaster for the US. Not only would they lose a large part of their annual subsidy of effectively free goods and services, but countries switching to euro reserves from dollar reserves would bring down the value of the US currency. Imports would start to cost Americans a lot more and as increasing numbers of those holding dollars began to spend them, the US would have to start paying its debts by supplying in goods and services to foreign countries, thus reducing American living standards. As countries and businesses converted their dollar assets into euro assets, the US property and stock market bubbles would, without doubt, burst. The Federal Reserve would no longer be able to print more money to reflate the bubble, as it is currently openly considering doing, because, without lots of eager foreigners prepared to mop them up, a serious inflation would result which, in turn, would make foreigners even more reluctant to hold the US currency and thus heighten the crisis.

There is though one major obstacle to this happening: oil. Oil is not just by far the most important commodity traded internationally, it is the lifeblood of all modern industrialised economies. If you don't have oil, you have to buy it. And if you want to buy oil on the international markets, you usually have to have dollars. Until recently all OPEC countries agreed to sell their oil for dollars only. So long as this remained the case, the euro was unlikely to become the major reserve currency: there is not a lot of point in stockpiling euros if every time you need to buy oil you have to change them into dollars. This arrangement also meant that the US effectively part-controlled the entire world oil market: you could only buy oil if you had dollars, and only one country had the right to print dollars - the US.

If on the other hand OPEC were to decide to accept euros only for its oil (assuming for a moment it were allowed to make this decision), then American economic dominance would be over. Not only would Europe not need as many dollars anymore, but Japan which imports over 80% of its oil from the Middle East would think it wise to convert a large portion of its dollar assets to euro assets (Japan is the major subsidiser of the US because it holds so many dollar investments). The US on the other hand, being the world's largest oil importer would have, to run a trade surplus to acquire euros. The conversion from trade deficit to trade surplus would have to be achieved at a time when its property and stock market prices were collapsing and its domestic supplies of oil and gas were contracting. It would be a very painful conversion.

The purely economic arguments for OPEC converting to the euro, at least for a while, seem very strong. The Euro-zone does not run a huge trade deficit nor is it heavily endebted to the rest of the world like the US and interest rates in the Euro-zone are also significantly higher. The Euro-zone has a larger share of world trade than the US and is the Middle East's main trading partner. And nearly everything you can buy for dollars you can also buy for euros - apart, of course, from oil. Furthermore, if OPEC were to convert their dollar assets to euro assets and then require payment for oil in Euros, their assets would immediately increase in value, since oil importing countries would be forced to also convert part of their assets, driving the prices up. For OPEC, backing the euro would be a self-fulfilling prophesy. They could then at some later date move to some other currency, perhaps back to the dollar, and again make huge profits.

But of course it is not a purely economic decision.

So far only one OPEC country has dared switch to the euro: Iraq, in November 2000[2,3]. There is little doubt that this was a deliberate attempt by Saddam to strike back at the US, but in economic terms it has also turned out to have been a huge success: at the time of Iraq's conversion the euro was worth around 83 US cents but it is now worth over $1.05. There may however be other consequences to this decision.

One other OPEC country has been talking publicly about possible conversion to the euro since 1999: Iran[2,4], a country which has since been included in the George W. Bush’s ‘axis of evil’.

A third OPEC country which has recently fallen out with the US government is Venezuela and it too has been showing disloyalty to the dollar. Under Hugo Chavez’s rule, Venezuela has established barter deals for trading its oil with 12 Latin American countries as well as Cuba. This means that the US is missing out on its usual subsidy and might help explain the American wish to see the back of Chavez. At the OPEC summit in September 2000, Chavez delivered to the OPEC heads of state the report of the 'Interrnational Seminar on the Future of Energy’, a conference called by Chavez earlier that year to examine the future supplies of both fossil and renewable energies. One of the two key recommendations of the report was that ‘OPEC take advantage of high-tech electronic barter and bi-lateral exchanges of its oil with its developing country customers’[5], i.e. OPEC should avoid using both the dollar and the euro for many transactions.

And last April, a senior OPEC representative gave a public speech in Spain during Spain’s presidency of the EU during which he made clear that though OPEC had as yet no plans to make oil available for euros, it was an option that was being considered and which could well be of economic benefit to many OPEC countries, particularly those of the Middle East[6].

As oil production is now in decline in most oil producing countries, the importance of the remaining large oil producers, particularly those of the Middle East, is going to grow and grow in years to come[7].

Iraq, whose oil production has been severely curtailed by sanctions, is one of a very small number of countries which can help ease this looming oil shortage. Europe, like most of the rest of the world, wishes to see a peaceful resolution of the current US-Iraqi tensions and a gradual lifting of the sanctions - this would certainly serve its interests best. But as Iraqi oil is denominated in euros, allowing it to become more widely available at present could loosen the dollar stranglehold and possibly do more damage than good to US economic health.

All of this is bad news for the US economy and the dollar. The fear for Washington will be that not only will the future price of oil not be right, but the currency might not be right either. Which perhaps helps explain why the US is increasingly turning to its second major tool for dominating world affairs: military force.

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FURTHER READING

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