Petrodollar or Petroeuro?

A new source of global conflict

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The current political and economic rift between the US and the European Union has been called a clash of civilizations. Its major cause is a struggle over the gains to be had from producing the world's leading currency

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No observer of the lead-up to the war in Iraq and its aftermath could have failed to notice that the level of cooperation between Europe and America was extremely low. France and Germany were very strong opponents of the US/UK invasion and even after the war was declared over, disagreements persisted over the lifting of sanctions and how Iraq should be run. So was this just a one-off tiff or was it a symptom of deeper flaws in the relationship? I believe that the war on Iraq illustrated for the first time that continental Europe, led by France and Germany, no longer wishes to follow the Americans politically, although what has been termed a 'clash of civilisations'[1] is probably better viewed as a 'clash of economies'.

While disagreements over the US trade barriers on steel imports or the European restrictions on imports of American genetically modified crops have attracted widespread comment, the most intense economic rivalry of all has received far less media attention than it perhaps should: this is the rivalry between the dollar and the euro for the position of world reserve currency, a privileged status that has been held by the dollar ever since the Bretton Woods agreement nearly 60 years ago.

At present, approximately two thirds of world trade is conducted in dollars and two thirds of central banks' currency reserves are held in the American currency which remains the sole currency used by international institutions such as the IMF. This confers on the US a major economic advantage: the ability to run a trade deficit year after year. It can do this because foreign countries need dollars to repay their debts to the IMF, to conduct international trade and to build up their currency reserves. The US provides the world with these dollars by buying goods and services produced by foreign countries, but since it does not have a corresponding need for foreign currency, it sells far fewer goods and services in return, i.e. the US always spends more than it earns, whereas the rest of the world always earns more than it spends. This US trade deficit has now reached extraordinary levels, with the US importing 50% more goods and services than it exports. So long as the dollar remains the dominant international currency the US can continue consuming more than it produces and, for example, build up its military strength while simultaneously affording tax cuts.

Getting a share of this economic free lunch has been one of the motivations, and perhaps the main motivation, behind setting up the euro[2]. Were the euro to become a reserve currency equal to, or perhaps even instead of, the dollar, countries would reduce their dollar holdings while building up their euro savings. Another way of putting this would be to say that Eurozone countries would be able to reduce their subsidy to American consumption and would find that other countries were now subsidising Eurozone consumption instead.

A move away from the dollar towards the euro could, on the other hand, have a disastrous effect on the US economy as the US would no longer be able to spend beyond its means. Worse still, the US would have to become a net currency importer as foreigners would probably seek to spend back in the US a large proportion of the estimated three trillion dollars which they currently own. In other words, the US would have to run a trade surplus, providing the rest of the world with more goods and services than it was receiving in return. A rapid and wholesale move to the euro might even lead to a dollar crash as everyone sought to get rid of some, or all, of their dollars at the same time. But that is an outcome that no-one, not even France or Germany, is seeking because of the huge effect it would have on the world economy. Europe would much prefer to see a gradual move to a euro-dollar world, or even a euro-dominated one.

>>> *A move away from the dollar towards the euro could have a disastrous effect on the US economy*

It turns out that there is a small group of countries which is playing the arbiter in this global contest. These are the world's oil exporters, in particular OPEC and Russia. Ever since the days when the US dominated world oil production, sales of oil and natural gas on international markets have been exclusively denominated in dollars. This was partly a natural state of affairs since, up until the early 1950s, the US accounted for half or more of the world's annual oil production. The tendency to price in dollars was additionally reinforced by the Bretton Woods agreement which established the IMF and World Bank and adopted the dollar as the currency for international loans.

The vast majority of the world's countries are oil importers and, since oil is such a crucial commodity, the need to pay for it in dollars encourages these countries keep the majority of their foreign currency reserves in dollars not only to be able to buy oil directly but also to protect the value of their own currencies from falling against the dollar. Because a sudden devaluation of a country's currency against the dollar would lead to a jump in oil prices and a possible economic crisis, every country's central bank needs dollar reserves so as to be able to buy its own currency on the foreign exchange markets when its value needs to be supported.

The fact that oil sales and loans from the IMF are dollar-denominated also encourages poorer countries to denominate their exports in dollars as this minimises the risk of losses through any fluctuations in the value of the dollar. The knock-on effect of this is that, since many of these exports are essential raw materials which richer countries need to import, their denomination in dollars reinforces the need for rich countries to keep their own currency reserves in dollars.

While the denomination of oil sales is not a subject which is frequently discussed in the media, its importance is certainly well understood by governments. For example, when in 1971 President Nixon took the US off the gold standard, OPEC did consider moving away from dollar oil pricing, as dollars no longer had the guaranteed value they once did. The US response was to do various secret deals with Saudi Arabia in the 1970s to ensure that the world's most important oil exporter stuck with the dollar[3]. What the Saudis did, OPEC followed. More recently, in June 2003, the Prime Minister of Malaysia publicly encouraged his country's oil and gas exporters to move from the dollar to the euro. The European and American reactions were polar opposites: the EU's Energy Commissioner, Loyola de Palacio, welcomed the suggestion, saying that 'in the future the euro is [going to be] taking a place in the international markets in general as the money of exchange' and that this was 'a matter of realism'[4]. Her counterpart in the US, the director of the Energy Information Administration, Guy Caruso, said that he couldn't see 'any particular merit' in the move and that over the long run 'the dollar's always won out'[5]. Either way, Malaysia is only a relatively minor oil exporter, so what it does can only have a very limited effect. A switch by a major oil exporter would be of far greater significance.

The first country to actually make the switch was a very important oil exporter indeed: Iraq, in November 2000[6,7]. Before the war in Iraq began, some observers, myself included, argued that this might well be a major reason for the US desire to invade and the strong Franco-German opposition to the invasion[8,9]. Corroborating evidence included the apparent influence which loyalty (or lack thereof) to the dollar seemed to have on the US attitude towards other OPEC members. Iran had been talking of selling its own oil for euros[6,10] and was subsequently included in George Bush's 'axis of evil'. Venezuela, another important oil exporter, had started bartering some of its oil, thus avoiding the use of the dollar, and was encouraging OPEC to do likewise[11] - and the US was widely suspected in having played a part in the attempted coup against the Venezuelan president, Hugo Chavez.

Semi-official confirmation that petro-currency rivalry was at the heart of the split between France and Germany, on the one hand, and the US, on the other, was provided by Howard Fineman, the chief political correspondent for Newsweek, in an article he wrote in April 2003, in the aftermath of the war. The Europeans and Americans were then arguing over whether the UN's oil-for-food programme in Iraq should remain in place or not. Using the term 'clash of civilisations' to describe the divide which was developing, Fineman explained that the disagreement had little to do with the French calls for the search for weapons of mass destruction to resume and for sanctions to remain in place until the search was complete. Instead, Fineman said, it was mainly about the dollar vs the euro. Citing White House officials and a presidential aide, he explained that the dispute between the two continents was really about 'who gets to sell - and buy - Iraqi oil, and what form of currency will be used to denominate the value of the sales. That decision, in turn, will help decide who controls Iraq, which, in turn, will represent yet another skirmish in a growing global economic conflict. We want a secular, American-influenced pan-ethnic entity of some kind to control the massive oil fields (Iraq's vast but only real source of wealth). We want that entity to be permitted to sell the oil to whomever it wants, denominated in dollars.' Fineman concluded his article by confidently predicting that future Iraqi oil sales would be switched back to dollars[1].

Fineman's White House sources would appear to have been reliable as that is precisely what has happened: when Iraqi oil exports resumed in June of last year, it was announced that payment would be in dollars only[12,13]. It was also decided that the billions of Iraqi euros which were being held in a euro account, controlled by the UN under the oil-for-food programme, were to be transferred into the Development Fund for Iraq, a dollar account controlled by the US[13,14,15].

Furthermore, Youssef Ibrahim, a former senior Middle East correspondent for the *New York Times* and energy editor on the *Wall Street Journal,* who is a member of the influential Council on Foreign Relations, has called Iraq's switch to the euro 'another reason' for the war, saying that a general move by oil producers to the euro would be a 'catastrophe' for the US[16].

America's willingness to use violence to defend its economic interests does not seem to have reduced the number of oil exporters considering switching to the euro as they recognise that their use of the dollar enables the US to build up its military strength. In addition to Malaysia, Indonesia has the switch under consideration[17] while Iran has been shifting its currency reserves into euros. Moreover, according to the Vice-President of the Iranian central bank, it has actually sold some of its oil to Europe for euros and is encouraging members of an Asian trade organisation, the Asian Clearing Union, to pay for Iranian oil in the European currency[18]. Along with Malaysia, it is also at the forefront of efforts to establish a new gold-backed currency, the Islamic Gold Dinar, to be used in international trade amongst Muslim countries instead of both the dollar and the euro[19]. In a further development, in June 2004, Iran announced that it had plans to establish an oil-trading market for Middle Eastern and OPEC producers which could threaten the dominance of London's International Petroleum Exchange and New York's Nymex[20]. Such a move could help remove some of the technical difficulties that exist with a switch away from dollar-denomination of oil sales.

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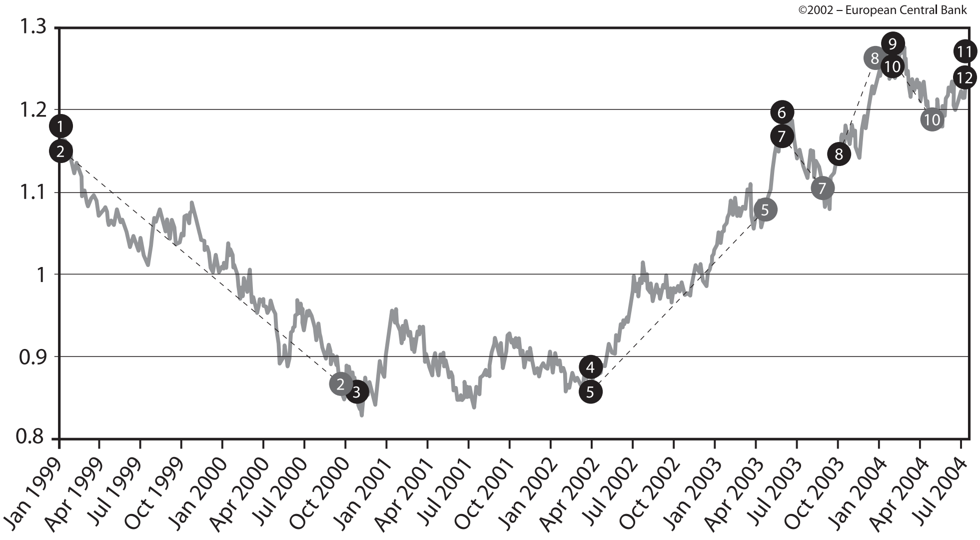
It is therefore not surprising to find that, just as with Iraq, the European Union and the US are dealing with Iran in very different ways. While the EU has been holding trade negotiations with Iran[21] and involved in dialogue about its nuclear programme, the US has refused to get involved in direct talks with the Iranian government which it views as 'evil'. The American Enterprise Institute, a highly influential American 'think tank', has in fact been actively calling for 'regime change'[22] and, although this policy has yet to be officially endorsed by the Bush administration, in July 2004 it was claimed in the British press that a senior official of the Bush administration had indicated that, if re-elected, Bush would intervene in the internal affairs of Iran in an attempt to overturn the Iranian government[23,24].

European enthusiasm for the 'petroeuro' also appears undampened by the US takeover of Iraq. Since the war, the European Union has been

The battle to become the world's key currency



Min=0.8252 (26 Oct 2000) – Max=1.2858 (17 Feb 2004)

Source for numeric data: http://www.ecb.int/stats/exchange/eurofxref/html/eurofxref-graph-usd.en.html#1999

1) **January 1999:** launch of the euro.
2) **January 1999 – Oct 2000:** euro in "bear market" versus the dollar.
3) **November 2000:** Iraq switches oil sales to euro. Euro's fall versus the dollar is halted.
4) **April 2002:** senior OPEC representative gives speech in which he states that OPEC would consider possibility of selling oil in euros.
5) **April 2002 to May 2003:** euro in "bull market" versus the dollar.
6) **June 2003:** US switches Iraqi oil sales back to dollar.
7) **June 2003 to September 2003:** euro falls versus dollar.
8) **October 2003 to early February 2004:** statements by Russian and OPEC politicians/officials that switch to euro for oil sales is being considered. Euro's value versus the dollar increases.
9) **10 February 2004:** OPEC meets and no decision to switch to euro is taken.
10) **February 2004 to May 2004:** euro falls versus the dollar.
11) **June 2004:** Iran announces intention to establish oil-trading market to rival those of London and New York.
12) **June 2004:** euro's value versus the dollar begins to increase again.

actively encouraging Russia, another opponent of the US invasion, to move to euro oil and gas sales. In October 2003, during a joint press conference with Germany's Prime Minister Gerhard Schroeder, the Russian President Vladimir Putin declared that Russia was thinking about selling its oil for euros. A few days later, the European Commission President, Romano Prodi, said, after a summit between Russia and the European Union, that Russia was now drawn to having its imports and exports denominated in euros[25,26].

In December 2003, speculation about the future roles of the dollar and the euro increased when OPEC Secretary General Alvaro Silva, a former Venezuelan oil minister, said that the organisation was now considering trading in euros or in a basket of currencies other than the dollar, as the US currency was declining in value[27]. Although a few days later the Saudi oil minister Ali al-Naimi said that OPEC would not be discussing a switch to the euro at its next meeting (comments reinforced by the Qatari President of OPEC and the Algerian oil minister[28]), articles discussing a possible move continued to appear in the media[29,30] and the euro's value against the dollar soared. Despite the speculation, no decision to move to the euro was taken at OPEC's meeting in early February 2004 and thereafter the euro's value fell back again.

In fact, close inspection of the dollar-euro exchange rate shows that since the euro's introduction in January 1999, petro-currency rivalry appears to have played an important part in swinging the rate one way or the other (see Graph). The markets, it seems, have noticed the importance of what is happening. On the other hand, the lack of an open discussion of the issues suggests that politicians and bankers are keen to move ahead with their plans with little or no explanation to the general public.

Should we not, however, be debating more openly what kind (or kinds) of international financial structure(s) we want to adopt, since the question has potentially huge implications for the stability of the world economy and for peace and stability in oil-exporting countries? A good starting point for such a debate would be the recognition that no country or countries should be allowed to dominate the system by controlling the issuance of the currency or currencies used. Similarly fundamental would be to prevent any country from running a persistent trade surplus or deficit so as to avoid the build up of unjust subsidies, unpayable debts and economic instability. At Bretton Woods, John Maynard Keynes, who understood how important these two conditions were, proposed a system which would have met them, but his proposal was rejected in favour of the dollar[31].

The dollar, though, is no longer a stable, reliable currency: the IMF has warned that the US trade deficit is so bad that its currency could collapse at any time[32]. Will we really have to wait for a full-blown dollar crisis before a public debate about creating a just and sustainable trading system can begin?

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