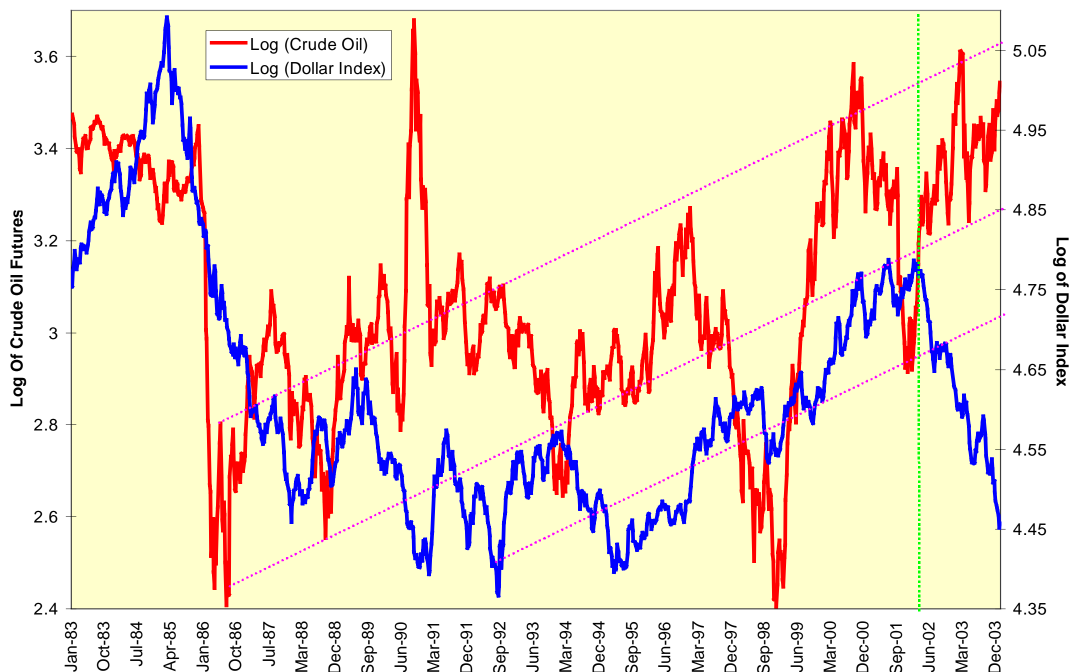
Trading Green Dollars For Black Gold

The notion of asking certain professionals to accept a check in return for services rendered would be laughable to all parties involved. The same verity applies on the grander scales of both domestic money and credit and international commerce. The fiat value assigned to a piece of paper can be created, destroyed or modified at whim, while the goods and services for which it is exchanged presumably have a real, or at least a static, value.

Our friends - and I do use the term loosely - at OPEC periodically rediscover to their chagrin just how exposed they are to this oil-for-paper barter. Whenever the dollar weakens, as it certainly has over the past year, they threaten to switch the basis of their pricing from dollars to some other currency or basket of currencies or supranational scrip such as the International Monetary Fund's Special Drawing Rights.

Yawn.

Quite simply, there is no, nor should there be, any evidence whatsoever of any price period of dollar weakness leading to a subsequent increase in crude oil prices as recompense.



If anything, the opposite appears to have occurred on several occasions. The largest and most pronounced weakening of the dollar, that between 1985 and 1987 engineered by Paul Volcker in response to lower inflation, was joined in mid-course by a collapse in oil prices, engineered by a Saudi Arabia unhappy about bearing the costs of OPEC discipline. If anything, the collapse in oil gave Volcker a freer hand than he would have had otherwise to continue lowering interest rates as lower oil prices were interpreted by some as the cause of lower inflation, not as its effect.

The susceptibility of crude oil prices to political shocks such as the two wars with Iraq, and to global macroeconomic shocks such as the 1997-1998 Asian and Russian financial crises and the aftermath of September 2001 distorts its price history. But even with these distortions taken into account, nominal prices

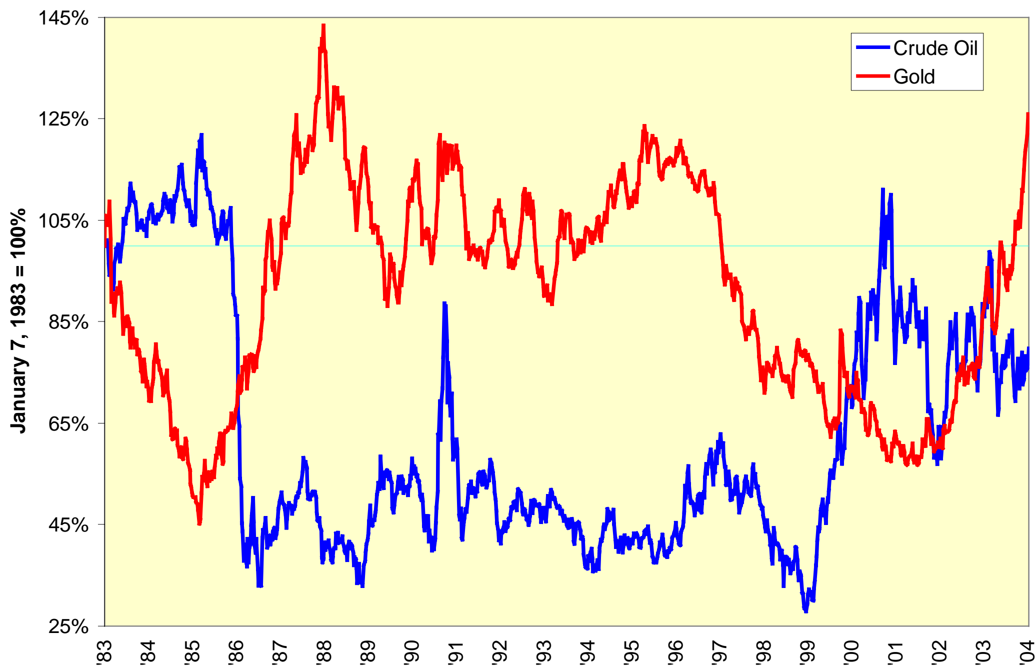
of crude oil have followed a broad growth channel higher since their 1986 low, and the dollar index followed a largely parallel growth channel between its 1992 low and the aftermath of September 2001. A growing global economy accounts for the former and the general vigilance of the Greenspan Fed against inflation account for these wide channels.

We are now at levels of crude oil prices reached several times earlier when the dollar was far stronger than it is today; in fact, crude oil prices are approaching at the top of the range established during the 1999-2000 surge. The dollar was nearly 30% higher at the time, and we hardly heard a word of thanks out of OPEC then for their good fortune to be receiving dollars in return for oil, did we?

The recently inverse relationship between oil and gold has negated much of the recent price increase for crude oil for those countries whose currencies are not pegged to the dollar. These economies, which include many of the non-oil producing emerging markets of South Asia, Latin American and Eastern Europe, have received a substantial tax cut by virtue of the dollar's weakness. Add this to the combination of lower debt service costs by virtue of lower dollar interest rates and an economic recovery, and it is small wonder the Morgan Stanley Emerging Market Index rose 64% from its March lows through the end of 2003.

Oil Is Not Gold

Crude oil, unlike gold, is a processed commodity whose longer-term supply and demand price elasticities are considerable. The concept of an inverse relationship between oil and the dollar as there is between gold and the dollar is meaningless. Over time, gold has maintained its purchasing power against a basket of dollar-denominated goods and services far better and with greater stability than has crude oil. This must be especially galling for the oil producers given the relative economic utilities of petroleum and gold.



Hedging For Fun, But Probably Not For Profit

Not only is crude oil priced in dollars worldwide, but most contracts for individual types of crude oil are written not in terms of absolute price but rather in terms of a differential to a marker crude such as Brent, produced in the British sector of the North Sea. Other contracts are written in what is called a "future formula cashout," meaning that the oil will be priced upon delivery according to a basket of refined products in that

local market. The operational considerations involved in setting oil prices in a basket of currencies instead of a single currency would disrupt the entire contractual structure of the world oil market. Both the producers and the consumers would be forced to engage in all manner of currency transactions to preserve the economics of their crude oil purchasing decisions. Adding complex basket hedging trades on a politically constructed basket of currencies to the tough business of oil trading does not strike me as one of those ingenious simplifications we all so enjoy in life.

In the current contractual structure, both the buyer and the seller have a single currency risk, that of their native currency to the dollar, and they are free to hedge that risk as they see fit. That OPEC as a group has not engaged in active hedging of their dollar risk when they had the opportunity to do so does not justify a demand for higher prices on their part.