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Saddam's last laugh

The Dollar Could be Headed for Hard Times if OPEC Switches to the Euro

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For a considerable time the United States has enjoyed a position of undisputed power among the world's countries. The superpower has been able, with some exceptions, to shape critical global policies to serve its own internal needs. Yet, its huge appetite for oil has left it dangerously vulnerable to the policies of Middle Eastern oil exporters and to the vicissitudes of the Israeli-Palestinian conflict.

Historically, the fact that oil prices are denominated in U.S. dollars has accorded the United States a position of strength. This was bolstered by a strong military presence in the Middle East, which was welcomed until recently by at least some oil exporting states. But the global potential of the European Union's currency (the euro) and the rising anti-U.S. sentiment in the Middle East coupled with a series of other recent events, may lead OPEC to change oil pricing from the dollar to the euro — a decision which could have a drastic effect on the U.S. economy and on global financial stability.

Setting the Stage for Crisis

U.S. domestic policy has generally been dominated by sentiment on two streets — Wall Street and Main Street. But since the Israeli-Arab war in 1973 and the accompanying Arab oil embargo against the United States, the importance of a third "street" — which might variously be called Oil Street or Middle East Street — has grown steadily. Before the year is out, this last street may well dominate the scene.

Oil is the energy and financial lifeline of the United States, Europe and Japan. It's a lifeline that runs through an area of intense conflict, where antagonism to U.S. and Israeli policies is as widespread as it is heated. In that context, rising tensions between the United States, the European Union, Russia and China could make for a dangerous and volatile crisis. Of the major powers, the United States is, in many ways, the most vulnerable. It certainly has the most to lose.

Take the issue of oil imports. In 1973, the U.S. imported 34 percent of the oil it consumed. By 1989, that had grown to 41 percent. Today, the U.S. imports over half of the oil it consumes, and consumption is growing steadily. Western Europe imports about half the oil it consumes, but that is down from 80 percent two decades ago, and consumption has stabilized. China imports 30 percent of its oil. Russia is an oil exporter.

Historically, the fact that oil prices have been denominated in dollars has benefited the U.S. economy enormously, as fluctuations in the value of the dollar had no direct effect on the price of oil for Americans. If the currencies of other countries decline against the dollar, the oil prices increase for those countries' citizens. For instance, last fall, oil prices increased faster for Europeans than for Americans, because the euro was plunging as petrol bills were soaring, triggering massive protests.

At the Bretton Woods international economic conference in 1944, the U.S. dollar was assigned a fixed value of $35 to an ounce of gold, and so pricing in dollars essentially meant pricing in gold. That system unraveled between the mid-1960s and the early 70s because the “guns-and-butter policy” during the Vietnam War created high inflation. Foreign dollar holders began losing confidence and converted their depreciating dollars into gold in increasing amounts.

By the early 1970s, U.S. gold supplies were running low. The U.S. devalued the dollar relative to gold in 1971 and, in 1973, unilaterally ‘de-linked’ it from gold. The U.S. dollar was no longer “as good as gold.” Yet, oil exporters — led by Iran, Venezuela and Saudi Arabia — decided to continue denominating the price of oil in U.S. dollars, ostensibly a sign of confidence in the United States and in its money. But, in fact, these countries had little choice but to continue to use U.S. dollars — there was simply no realistic global alternative at the time.

With oil linked to the dollar, and a substantial U.S. military presence in the Middle East, the position of the dollar seemed to be strong. At that time, Iran was the closest U.S. ally in the Persian Gulf and welcomed U.S. military presence. Iran was also the most powerful military force and the most populous country in the region, as well as the world’s second largest oil exporter.

To date, the oil-dollar link has given the United States a huge advantage in international trade. Corporations and countries carry out trade in U.S. dollars, making the U.S. Treasury and the U.S. Federal Reserve Board the ultimate arbiters of global monetary policy. However, the stability of the U.S. dollar, and by extension the global monetary system, partially depends on the financial policies of Persian Gulf countries that control nearly two-thirds of the world’s reserve of “black gold.”

That weakness became evident in 1979, when the Shah of Iran was overthrown by Ayatollah Khomeini’s Islamic revolution, and the United States lost its main military ally in the global oil patch. The price of oil shot up to $40 a barrel (about three times today’s level in real terms) and the value of the dollar plummeted relative to other currencies. The price of gold soared to $800 per ounce. The U.S. had to drastically increase interest rates — to 15 to 20 percent, causing the most severe recession since World War II — to encourage foreigners to hold onto their U.S. dollars rather than dump them for other currencies.

Today in the Middle East

We’re now in the midst of the worst Israeli-Palestinian crisis in a generation and the situation is at least as unstable as the 1973-1979 period. U.S.-Iranian relations are hostile and tense. The U.S. has troops based in Saudi Arabia, but they are not welcome. In the early 1990s, several governments and many people in the Persian Gulf region tolerated and even welcomed the presence of U.S. troops out of fear of Iraq’s dictator Saddam Hussein. Today, U.S. support to Israel in the face of the Palestinian struggle for statehood is not seen as that of an even-handed mediator. Rather, it has fueled more anti-U.S. sentiment.

Ariel Sharon who, as Defense Minister, presided over a terrible massacre of Palestinians during the Israeli invasion of Lebanon in 1982-83, has just become Prime Minister of Israel. He has vowed that Israel will maintain sovereignty over an undivided Jerusalem, the holy city claimed by both Israelis and Palestinians. Saddam Hussein, the architect of brutal internal repression in Iraq, has proclaimed himself a military champion of the Palestinian cause. Many in the region welcome him in that role, now more than ever, as a

counterweight to Mr. Sharon.

The U.S. also has an uneven policy in the Middle East concerning nuclear proliferation, winking at Israel's development of a substantial nuclear arsenal, and even selling it military hardware. Israel has avoided signing on to the Nuclear Non-Proliferation Treaty (NPT), to which Egypt and other Arab states belong. It is likely that Iraq, which has long sought nuclear weapons, still has nuclear ambitions. The United States has never promoted sanctions against Israel for its nuclear arsenal, but the U.S. supports sanctions against Iraq, Iran, and Pakistan. This contradiction has angered many countries in the region and may have stoked the ambitions of some of them for acquiring nuclear weapons.

Israel has so far refused to participate in discussions regarding a Middle East nuclear-weapons-free zone. The specter of a black market in nuclear materials has increased with the economic woes of Russia, making nuclear proliferation in the Middle East a growing threat.

U.S. Relations with Europe and Russia

Increasingly, the U.S. is at loggerheads with other global powers. In the past two years, U.S. and Russia have clashed more and more over security issues such as national missile defenses and the expansion of NATO. Russia, China and France have regularly opposed the U.S. and Britain regarding UN Security Council sanctions against Iraq. Given the Bush administration's determination to build national missile defenses and President Bush's stated indifference to the Anti-Ballistic Missile (ABM) Treaty, U.S.-Russian tensions are likely to flare up even more. China has already warned that existing non-proliferation arrangements may not survive should the U.S. decide to violate the ABM treaty.

U.S.- European relations are testy on a number of issues, ranging from trade to Europe's plan to create its own security force (the European Rapid Reaction Force), to the U.S. proposal to install a national missile defense system.

In this context of global tension, the U.S. economic vulnerability to Oil Street is particularly poignant. In the last two years, the euro has risen as a possible alternative currency to the U.S. dollar. OPEC, unhappy with U.S. Middle East policies, could decide to create the financial equivalent of the 1973 oil embargo against the United States by changing oil pricing policy from dollars to euros. That would make the euro a major global competitor with the U.S. dollar.

Linking Oil to the Euro

Last autumn, as a protest against U.S. Middle Eastern policy, Iraq asked the United Nations for permission, which the UN granted, to be paid for its oil in euros. (It needed UN permission because Iraq is selling oil under a supervised United Nations sanctions regime. Other countries would not need permission.) Iran subsequently raised the possibility of doing the same. Both these moves hint at the potential for a change in OPEC oil-pricing policy.

Pricing oil in euros rather than dollars could cause a tremendous flight from the dollar — possibly far greater than the one that led to the collapse of the gold-dollar connection in 1973 or the one that caused the steep decline of the dollar in 1979-80. Like any other currency, the U.S. dollar is vulnerable to the fast, panicky currency trades made possible by the computerization of the financial world. Yet the dollar

also has its own special vulnerability. Since it is the pre-eminent global currency, a large proportion of all the U.S. currency — half or more — is held abroad.

The desire of foreigners to hold dollars provides the United States with a great deal of financial power. But it could also make for a far faster fall, should holders of dollars decide to dump them. Though the underlying value of U.S. companies and real estate could stem the dollar's decline as those assets become cheap enough for holders of other currencies to want to buy, there is no predicting whether chaos and uncertainty would take hold first. In any case, the U.S. economy would likely be deeply damaged.

Russia has from time to time expressed an interest in tying itself closer to the euro. This would be more likely if the arms control dialog between the United States and Russia breaks down. If Persian Gulf oil exporters were to carry out an oil-pricing switch from dollars to euros in collaboration with Russia, a dangerous multi-sided confrontation could develop.

In sum, a dangerous confluence of events has emerged very rapidly in the last two years: a Middle East political crisis, rising U.S.-European Union differences, the introduction of the euro, U.S.-Russian and U.S.-Chinese tensions, and the inauguration in the United States of an administration that has far more unilateralist proclivities than any since the end of the Cold War.

U.S. Domestic Implications

United States domestic actions — such as attempts to open the Arctic National Wildlife Reserve (ANWR) to oil drilling — will not solve the global conflict over oil, money and Israel-Palestine. Opening ANWR would not make a significant dent in U.S. oil imports for years to come, if at all. Nor would ANWR drilling ease the complex political-military-financial issues that have made the U.S. dollar vulnerable. Opening ANWR would, however, create internal U.S. political strife and divert attention from the crisis on the Middle Eastern Oil Street.

Neither military power nor money will enable the United States to address global crises unilaterally, so the country has no choice but to abandon its overbearing unilateral policies and position itself as a better global citizen. For starters, it must foster cooperation with Europe and Russia, as well as create a just and even-handed Middle Eastern policy. For the world's sole super power to thumb its nose at the world is far more dangerous than most Americans realize. A cooperative approach would not only be more prudent; it would give the United States and the rest of the world the opportunity to consider new global monetary arrangements, which are needed in any case for a less vulnerable and more equitable global financial architecture.

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