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The US Dollar And Oil Pricing Revisited
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Once again, as has been customary whenever the US dollar dips relative to other currencies, many are making statements and even suggestions relating to the currency of oil pricing. Some are hinting that the euro, which has shot up to stardom, might be a better and safer currency for pricing oil without asking: better for whom?

The Indonesian president of the OPEC Conference, when asked whether OPEC might discuss the use of the euro, replied that some member countries were considering that. At the same time, Venezuela's Central Bank Director declared that his country had no interest in trading oil in a currency other than the US dollar and that it made no sense to do so. The IEA Executive Director rebuffed arguments by OPEC that current high oil prices were justified by the fall in the value of the US dollar, saying: "I did not hear that argument when the exchange rate was the contrary". Of course he would not have done.

While it is useful to refresh one's memory by going back to history, we will try to stick here to more recent events that are pertinent to the subject. Suffice it to note that in the 1930s, Iraq's Finance Minister, Sassoon Khedouri, insisted that the pound sterling, in which all payments to Iraq under the concession agreements were denominated and made, be linked to gold. This proved, in later years, to be of great financial benefit to most oil producers in the Middle East when the old pound lost its shine.

History
OPEC first referred to stabilization of prices and securing steady income during its founding meeting in Baghdad on 14 September 1960. However, it was not until the end of 1970 that the organization raised the issues of currency and inflation. Considering the value of the US dollar being an essential element for the determination of the member states' fiscal revenues, in addition to the deterioration in the purchasing power of the revenue per barrel due to inflation in prices of goods imported from industrial countries, OPEC resolved in Caracas on 12 December 1970 that: " In case of changes in the parity of monies of major industrial countries which would have an adverse effect on the purchasing power of member countries' oil revenues, Posted or Tax Reference Prices should be adjusted as to reflect such change".

The international monetary developments as of 15 August 1971 prompted OPEC, in its meeting in Beirut on 22 September 1971, to call for negotiations with the oil companies holding concessions in member countries. By 14 January 1972 there was no progress in negotiations. OPEC, in spite of a total loss of more than 11.5%, was asking for a hike of only 8.57% — which was the loss in value of the US dollar relative to gold. In fact, what OPEC was asking for was very close to what the International Maritime Conference had, at the time, announced: a minimum increase in the dollar freight rates of 8.6%. Finally, an agreement was reached in Geneva on 20 January 1972 that provided an immediate increase in the posted prices by 8.49%. The settlement also included provisions for further adjustments until 1975 based on an index that reflected changes in the dollar and other key currencies.

However in early 1973, while the industrialized countries were taking initiatives towards possible concerted action relating to energy issues, OPEC, in a confrontational mood, raised the issue of the US dollar and the purchasing power of oil revenues. Accordingly, in March 1973, an OPEC Ministerial Committee was formed to negotiate with the companies an amendment to the Geneva agreement that would secure full compensation for the devaluation of the dollar and to avoid any future loopholes. But it wasn't until 1 June 1973, after several meetings and breakdowns in negotiations, that agreement was reached between the companies and eight member countries (Abu Dhabi, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar and Saudi Arabia). This was done in the form of a supplement amending the Geneva agreement of 20 January 1972 and the other accords that followed it. The immediate effect of the new agreement was an increase of 6.1% in posted prices making the total increase, since the February 1973 dollar devaluation, 11.9%. Future increases were linked to changes in the exchange rate of the US dollar and 11 major currencies.

On 16 October, 1973 OPEC unilaterally decided to link posted prices to actual market prices. This was confirmed at the OPEC Conference of 20 November 1973 which reaffirmed the organization's belief that the pricing of petroleum, like the pricing of other internationally-traded manufactured goods, commodities and raw materials, should be market-oriented.

However, early in 1975, ahead of the Algiers conference of OPEC's Heads of State, the issue of the depreciation of the dollar made a comeback on the agenda of the OPEC ministerial conference. The Solemn Declaration of the Algiers March 1975 Conference made several references to pricing. Besides the imperatives of conservation of a depletable resource, its value in non-energy use and the cost of alternatives, the declaration added that pricing was to take into consideration the prices of manufactured goods, the rate of inflation and the terms of transfer of goods and technology for the development of OPEC countries. The declaration also pointed out that in spite of the apparent magnitude of adjustments to oil prices, the high rate of inflation and currency depreciation had wiped out most of the real value of price adjustments.

Not long after the Algiers Summit, the OPEC Conference decided on 11 June 1975 to adopt the use of the SDR (Special Drawing Rights) as a unit of account and was to define the modalities for the implementation of the SDR at its next Extraordinary meeting in Vienna on 24 September 1975. In the OPEC press release at the conclusion of that Extraordinary meeting on 27 September 1975 only a price increase of 10% was announced, and no mention was made of the SDR or the modalities for its implementation.

In December 1977, the OPEC Conference, which had made several price increases since linking posted prices to actual market prices, was once again expressing concern regarding the losses in purchasing power of member countries' export earnings. The weakening dollar and inflation were to be studied by the OPEC secretariat which was to propose remedial measures to safeguard member states' interests. In June 1978, the Conference expressed deeper concern and authorized a high level committee of experts chaired by a senior minister to tackle the stubborn issues of inflation and the fading dollar.

A year later the OPEC Conference noted with great anxiety the high rate of inflation and the dollar depreciation sustained over the preceding two years, the substantial erosion in oil revenues and the adverse effects on member countries developments. As a gesture of goodwill and in order to support efforts towards strengthening the US dollar and arresting inflationary trends, the Conference decided to correct, only partially, the price of oil. The increase was to be only 10% over 1979 and applied in quarterly increments. Along with the goodwill gesture there was an informal and an indirect threat to apply the full correction for inflation and currency instability if those elements continue to affect oil revenues.

Not long after the decision to fix prices for the whole of 1979 was taken, the OPEC Secretariat, in response to repeated enquiries, issued a press release stating: "Conference decisions in setting crude oil prices do not prevent member countries from making an upward adjustment in the light of their prevailing circumstances." The legal cover for that "free for all" situation was "Sovereign equality" of member countries mentioned in the OPEC Statues. In the period that followed, official prices were chasing market prices and whenever there was a lag in narrowing the gap, market premiums, signature bonuses and kickbacks made up for the difference.

In its endeavor to bring some stability and order to the market, the OPEC Conference, in its Geneva meeting on 28 June 1979, set the marker crude price at $18/B, limited to $2/B the market premium and made $23.5/B the maximum total price chargeable by any member country whether on account of quality, location advantage or market premium. That was the first time a price ceiling was set by OPEC.

After repeated price and ceiling price adjustments, OPEC, which had passed through an aggressive and confrontational phase throughout the 1970s, was drifting slowly into a retreat phase. A 10% production cut as of 1 June 1981 was a signal and a start of a period that was not so good for the organization.

Throughout the period that followed with OPEC's production and crude oil prices spiraling down, there was no mention of inflation or the value of the US dollar. After the effective abandonment of the fixed price system and the commencement of the battle for market share, the concern was again the US dollar. Not its value, strength or weakness against other currencies, but the dollars and at any price.

The end of 1986 marked the start of the OPEC Reference Price or Basket phase. On 20 December 1986, $18/B became OPEC's Reference Price. In theory it was staged as a return to the fixed price system but, as in real life, the dead never make a comeback. The Reference Basket Price was increased on 27 July 1990 to $21/B and finally set at a range of $22-28/B in March 2000.

Before finishing with history, it should be noted that in addition to the collective measures taken by OPEC, some member countries tried, individually, additional measures to protect their income during the periods of steep decline in the value of the US dollar. Some tried contracting in the Japanese yen and the German mark. That was strongly opposed by the Japanese and German Governments. The best that could be managed at the time was to get the desperate buyers to accept making payment on due date in yen, mark or other agreed currencies using the dollar conversion rate in force on the date of bill of lading (loading date). As payment was normally made 30 days after loading, the arrangement gave the seller protection against the drop of the dollar for only the 30 days between loading and payment. It also meant a loss for the seller if the dollar recovered during the 30 days.

As the dollar trend reversed, all such arrangements were promptly abandoned when some producers found themselves on the losing side. Needless to say, bankers would have achieved the same or better results by forward selling dollars whenever they considered proper. More recently Iraq, while continuing pricing in the US dollar, asked for payment in and kept its accounts in euros. This was basically a political gesture. However, it did make some gains for the Oil-for-Food funds when the euro went high against the dollar.

In summary, the pricing of crude oil and all contracts remained in the US dollar irrespective of the currency agreed upon for actual payment.

What Next?

All commodity prices, the US dollar, gold and other currencies change and fluctuate relative to each other in response to changing market fundamentals and other factors that influence their values.

It is true that the US dollar has fallen relative to the euro by more than 30% since July 2001 when the latter was at its lowest ($0.84). It is also true that the euro countries are enjoying the benefits of the cheaper dollar after a period of relative suffering when the euro was lower than its launching parity ($1.17) which was the basis of conversion of their old currencies.

As for OPEC and others whose exports are priced in the US dollar and who have chosen to accept the "Free Market" to be their price setter, it is only logical that they address the issue in a manner consistent with free market principles. For OPEC, the age of posted or set prices is now history and protecting their legitimate interests has to be within the accepted, transparent and fair norms.

The OPEC basket price range of $22-28/B was decided in March 2000 and was at the equivalent to €22.8-29.1/B. The monthly average prices of the OPEC basket in dollar and euro, of the time, for some selected months since March 2000 were as follows:

OPEC Basket Market Price

	$	**€**
March 2000	26.8	27.8
October 2000	32.5	36.8
June 2001	25.8	30.5
December 2001	16.9	19.0
March 2003	32.0	29.6
December 2003	29.5	23.79

In spite of the rise of the euro from $0.963 in March 2000 (the date of setting the OPEC price range) to around $1.24 now, the basket price in euros is still within the price range, had it been set in euros in March 2000.

It will not be realistic for OPEC to even think about pricing oil in a currency other than the US dollar. The dollar is the currency of the biggest importer of OPEC oil, aside from the fact that the currencies of most other oil importers and the OPEC countries themselves are dollar-related if not linked. It is by far the main currency of pricing for most of the internationally-traded commodities, goods and services. The dollar is also the currency of choice of most personal savings and trade in many countries such as Russia, FSU, Eastern Europe and others.

If OPEC is now of the opinion that the purchasing power of its barrel is lower than desired then it could change the target price range to the level it considers adequate. It would then have to use the tools available to it to steer the price to within the new range. In doing so, OPEC should consider carefully the consequences of such a move on its future market share, development of alternative oil supplies and other energy sources, world economic recovery and demand for OPEC oil.

I do not think that changing the currency of pricing oil from the US dollar to another currency is an option. However, OPEC may chose to change the present price range to a floating one that moves up and down linked to an index based on a basket of currencies. This will not compensate for the value erosion caused by inflation which is another factor to consider. A measure like the introduction of a floating price range will bring into play a new element of uncertainly and instability in an oil market already crammed with many unpredictable factors.

It is well known that many commodities, goods and services are often traded at different prices in different markets. Exporters take into consideration many factors before deciding their pricing policy in a specific market. They consider their market share, competition, their long-term presence and objectives as well as the standard of living, political relations and reciprocal trade. The price of oil, like any other commodity in a free market, will fluctuate in response to changes in market fundamentals with the balance between supply and demand being the most important.

During the period of set prices OPEC often adjusted prices to compensate for the loss in the purchasing power of the barrel due to depreciation in the value of the US dollar against other currencies as well as inflation. While the dollar was going up and down and the adjustment for it could be positive or negative, inflation and correction for it was not reversible because of its cumulative nature. To illustrate this, we can look at the effects of the exchange rate and inflation since 1973 when OPEC first dealt with the issue of price correction to compensate for their losses.

Crude Oil Price in Nominal and Real Terms
(US Dollars Per Barrel)
Base: 1973 = 100

Year	Nominal Oil Price	Nominal Price Adjusted for		
		Exchange Rates	Inflation	Combined
1973	3.05	3.05	3.05	3.05
1974	10.73	11.06	9.39	9.68
1975	10.73	10.86	8.37	8.47
1976	11.51	12.57	8.18	8.93
1977	12.39	13.41	8.01	8.67
1978	12.70	12.60	7.64	7.58
1979	17.25	16.48	9.45	9.04
1980	28.64	27.33	13.89	13.26
1981	32.51	35.66	14.18	15.55
1982	32.38	39.76	12.97	15.93
1983	29.04	38.79	10.90	14.57
1984	28.20	41.44	9.97	14.66
1985	27.01	41.16	9.06	13.80
1986	13.53	16.94	4.40	5.50
1987	17.73	19.88	5.57	6.25
1988	14.24	15.54	4.32	4.72
1989	17.31	19.87	5.00	5.74
1990	22.26	23.38	6.07	6.38
1991	18.62	19.84	4.85	5.16
1992	18.44	19.24	4.62	4.82
1993	16.33	18.88	3.96	4.58
1994	15.53	17.90	3.66	4.22
1995	16.86	18.63	3.85	4.26
1996	20.29	22.60	4.51	5.03

1997	18.68	22.33	4.06	4.86
1998	12.28	14.91	2.63	3.19
1999	17.47	21.67	3.68	4.57
2000	27.60	37.76	5.67	7.76
2001	23.12	32.65	4.64	6.56
2002	24.36	33.13	4.80	6.53

It is very clear that for 28 of the 30 years since 1973 the correction for the exchange rate boosted the nominal price (except 1978 and 1979) while inflation was the element causing the major losses all the years. It is also of interest to note that the average nominal price for the OPEC basket of $24.36/B for the year 2002 was equivalent to only $6.53/B in 1973 dollars. The nominal price was more than eight times as much while the real price was only just over double. The main culprit was inflation and not the dollar.

It might also be useful to look at how the impact of inflation and currency fluctuations on the spot reference basket changed since 1990 when OPEC set the reference price for the basket at $21/B.

In the following table, the exchange rate index is a measure of the appreciation/depreciation of the US dollar versus a basket consisting of the US $, the euro, the Japanese yen, the pound sterling and the Swiss franc. The currencies are weighted by the average value of merchandize imports of OPEC member countries from these countries over the period 1998-2000. The inflation index measures the inflation in the countries of the currencies basket (Consumer Price Index) weighted by merchandize imports, the same weights used for the currency index.

Base: July 1990 = 100

Month	Exchange Rate Index	Inflation Index	OPEC Basket Market Price	Adjusted Prices		
				For Exchange Rate	For inflation	Combined
July 90	100.00	100.00	16.26	16.26	16.26	16.26
July 91	704.79	100.39	18.29	19.07	17.43	18.27
July 92	93.39	107.96	19.74	18.44	18.28	17.08
July 93	104.57	111.14	15.96	16.69	14.36	15.02
July 94	99.65	113.69	17.43	17.37	15.33	15.28
July 95	94.10	116.47	15.63	14.70	13.42	12.62
July 96	98.56	119.04	19.29	19.01	16.21	15.97
July 97	107.18	121.44	17.86	19.14	14.70	15.76
July 98	110.13	123.30	11.67	12.85	9.46	10.42
July 99	111.81	124.70	18.28	20.44	14.66	16.39
Mar 2000	115.03	126.77	26.71	30.73	21.07	24.24
Nov 2000	124.82	128.61	31.22	38.97	24.27	30.30
July 2001	126.19	130.50	23.73	29.95	18.19	22.95
July 2002	114.29	132.23	25.13	28.72	19.01	21.72
July 2003	105.69	134.65	27.43	28.99	20.37	21.53
Oct 2003	102.84	135.20	28.54	29.35	21.11	21.71

Between July 1990 and November 2003 the monthly exchange rate index was lower than 100 for 48 months while it was higher than 100 for the other 140 months. The lowest exchange rate index recorded was 92.27 for August 1992 while the highest was 126.73 for June 2001. The latest decline in the index started in March 2000 dropping by about 20 points over 20 months to reach 102.84 for October 2003. The inflation index, because of its cumulative nature, had steadily increased from 100 for the base month July 1990 to reach 135.20 in October 2003.

Conclusions

- OPEC's efforts to monetize its petroleum resources will continue to be derived from the sales of petroleum and related products priced in the US dollar.
- Production management will remain OPEC's only tool that will influence the unit price of its exported commodities and revenues.
- Introducing a currency indexed basket price range will be very harmful to market stability.
- Until such time OPEC's market share is substantial, its influence on the oil market will remain constrained.
- Changing the oil pricing currency is not an option.