Oil Deals in Euro: Opportunities and Challenges

Iranian government has recently announced that its foreign currency transactions and foreign exchange reservation would be based on euro thereafter, bringing the euro-oil relation into spotlight in economic circles.

Known as spiritual father and founder of the euro, Jacques Santer, a member of the European Parliament (MEP) and former president of the European Commission, the European Union's executive body, delivering speech in a Europe-PGCC joint economic summit some years ago proposed the Persian Gulf oil producing states to replace the dollar with the euro in their deals.

He added, "I am certain if the euro is the basic currency for oil contracts, confidence and cooperation between the European Union and the Persian Gulf Cooperation Council (PGCC) will be boosted, leading to stabilization of the international market."

The "Eghtesad-e-|Energy" monthly took the government's recent decision as a good opportunity to sturdy the euro-oil relation.

After the "Breton Woods" monetary system dominated in the world in 1944 and particularly following its collapse and the dollar's floating in 1971, the dollar has been always considered and used as the main hard currency for international pricing and trading and the United States has used it as an effective tool for carrying out its hegemonic economic policies in the world.

Given oil pricing in dollar and the first oil shock in 1973 that sharply increased the commodity's price in the world markets, the demand for the dollar considerably grew while the currency was falling and the depreciation in its value had turned it into hot money. The mentioned developments, however, helped hot dollars turn into petrodollars.

On the other hand, OPEC member states' purchasing power, thanks to the dollar's weakening against other valid currencies, was greater when compared to that of industrialized countries. As the majority of OPEC member countries were dominated and influence by the United States, the increase in oil price during the first shock helped a considerable amount of dollars return to the U.S.

The hike in the world oil prices during recent years has also served the U.S. macroeconomic policies.

No doubt, all countries of the world were under great pressure when the Breton Woods monetary system dominated and helped the dollar rule the global economy. Naturally, the European community and Japan endured greatest suffering because they were developed states and enjoyed strong economies, having the ability to compete with the United States in many fields particularly technology. However, the U.S. economy and the dominance of the dollar have been the main factors that have kept them as the second-grade economic powers.

For these reasons, European states have strong motives for confronting the global dominance of the dollar – the motives outlined overtly and covertly in their national strategies since long ago. The European states excelled the U.S. as their economies merged and the unity reached the turning point of establishing a unified monetary unit – euro. Comparison of figures and statistics in the euro lands and the U.S. shows that Europe enjoys the capacity to compete with the U.S. in different areas, including population, gross domestic product (GDP), share in world trade, productivity, and the like. The point is that none of the member states of the European Monetary Union was not able to compete with the United States individually. Therefore, if the dollar dominance in the world economy ends and the euro gradually gains an appropriate status and plays a major role, the era of the United States' hegemony in the international economy is terminated, as well.

What mentioned above is only the ideals of the European community, which needs to take the historical opportunities to identify and settle the problems at due time in the long run.

The euro will leave the dollar behind only after playing an effective role in the pricing of products and such a role demands constant strengthening of the euro and permanent weakening of the dollar. Oil, too, is an important factor as the commodity is regularly traded in huge volumes. If the OPEC oil exporting member states sell the commodity in euro and keep their currency reserves in euro, the demand for euro will grow while the demand for dollar will be lower, leading to the strengthening of the European currency and weakening of the U.S. monetary unit. Crude oil deals by itself constitute some 10 percent of the world's total trade.

So, if the oil exporting countries use the European currency in their deals, they could play an influential role in strengthening of the euro and weakening of the dollar and helping the European community achieve its ultimate goal. The oil exporting states, however, are faced with a main paradox. Although the oil exporting countries, like other states, will take advantage of loosening the dollar grip on the world economy in the long run, the weakening of the dollar will damage them in the short and medium terms, during which crude oil price is based on the currency. The weakening of the dollar against other currencies particularly yen and euro reduce the purchasing power of the oil exporting countries in Japanese and European markets.

In other words, support for the euro will serve the oil exporting countries in the long run and these countries suffered a lot from the dollar rule (particularly when the dollar had been devalued), but the issue is different in the short run and the depreciation of the dollar is tantamount to the weakening of these states' purchasing power in non-dollar blocks. The problem is more serious for the Islamic Republic of Iran that has severed trade ties with the United States .

Hence, if the European Monetary Union expects the oil exporting countries (OPEC and non-OPEC states) to use euro in their deals in a bid to support the European currency in the long run, it needs to compensate for their losses in an appropriate way and pay them subsidies As mentioned before, when the euro manages to play a role in the pricing process of cruse oil, the paradox is resolved and there is no need for granting subsidies.

However, the oil exporting countries should know that dependence on the euro for pricing crude in the long run is a mistake like the blunder they made in dealing with the dollar. The crude pricing should be based on a basket of at least three hard currencies – yen, dollar, and euro – to ensure more stability and make up for their individual fluctuations.

In addition, OPEC should regularly regulate oil prices according to the dollar depreciation.

OPEC and Production Paradox

World oil prices, under the effect of the relative calm of two sets of factors, namely psycho-political issues and natural disasters, continued their downward trend. And even OPEC's decision to reduce crude oil production on October 20, 2006 failed to make any change in this trend Many analysts attributed the OPEC's ineffective decision to the market's lack of confidence in seriousness of OPEC members in abiding by its decisions. But perhaps such a justification is not very convincing as lack of seriousness has always been the case with OPEC members. Yet, OPEC decisions regarding output cut have always had psychological effects on the market, relatively increasing prices. Therefore another explanation should be found for the current situation of the oil market.

It seems that OPEC has faced a kind of paradox during the last few months which is unprecedented in the organization's history. It may last for sometime and, thus, it is a necessity to get an insight into this subject.

To understand this contrast, it should be mentioned that at least during the last three decades and following oil price shocks in the 1970s, the industrial countries, along with their energy planning and strategies, had relied on oil storage (strategic and commercial), as well as OPEC's spare capacities to control price shocks and to make up for sudden and short term shortages in the market. Experience has shown that taking from strategic reserves to control short term oil market fluctuations is neither compatible with the objectives of their oil storage policy, nor is it simply feasible since by doing so, the market may see it as the emergence of a critical situation in international conditions and its psychological impact may even aggravate the problems. Therefore, OPEC's spare production capacities have proved to be of higher importance for controlling market fluctuations. Relying on its spare capacity, OPEC has mainly played the role of the market regulator.

With the worldwide hike in oil demand and an increase in OPEC's oil output during the past two years, the organization's spare production capacities stayed at its lowest or even at zero levels. It was only Saudi Arabia claiming to have a spare capacity of about one million to 1.3 million barrels per day. But oil analysts had serious doubt about such a claim. Lack of OPEC's spare production capacity had intensified the market's sensitivity and vulnerability during this period.

In addition, the industrial countries which are members of International Energy Agency had been forced to increase their oil storage which in turn resulted in higher demands for oil to store.

With more stability coming to the market along with relative decrease in world crude oil demand in recent months, OPEC has felt obligated to reduce its output. The reduction of OPEC output means an increase in the spare production capacity of the organization's members. As it was mentioned, spare production capacity did not exist for a relatively long time. Once again the existence of spare production capacity brings some relief to the world oil market, the psychological impact of which is apparently stronger than the effect of actual OPEC physical output cut. In such circumstances, the decision by OPEC to reduce production has caused a reverse effect. The prevailing situation is predicted to continue until the time that OPEC's spare production capacity reaches a sufficient level from the market's point of view.