Oil Prices - A Little More of the Story

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A few days ago, I wrote a post titled Why Are Oil (and Gasoline) Prices So Low? Since then, OPEC has voted to cut oil production 1.5 million barrels a day. In spite of this, the price of oil is about 5% lower. The purpose of this post is to add an update, with a little more of the story about why the price of oil is dropping more than some of us would expect.

One of the issues I mentioned in that story was

4. Rising value of the dollar

I noted in that post that the price of oil seems to drop as the price of the dollar rises against currencies such as the Euro. As I delve into the question more, I am starting to learn more about why the value of the dollar has recently been rising. It seems that the rising value of the dollar is tied to a combination of things--one is the flight to the US dollar for safety, another is the unwind of the carry trade, and a third is margin calls on hedge funds and other borrowers. The rising level of the dollar because of these issues seems to be a major contributor to the recent decline in oil prices.

This is an excerpt from a Reuters article talking about the connection with the flight to safety:

Treasuries ride high on dollar inflows, for now

> NEW YORK (Reuters) - As global investors reverse trades in foreign currencies and stocks and run to the U.S. dollar amid fears of a global recession, they are sheltering much of the cash they salvage in a familiar safe harbor, the U.S. government bond market.
>
> In the near term, Treasury debt prices stand to gain from this capital flight out of a range of other assets across the globe.
>
> But when the flow back to dollars ultimately abates, a big risk awaits holders of U.S. government bonds. If the dollar falls out of favor with global investors just as the government accelerates debt issuance to pay for financial system rescues, bond yields will spike, analysts warn.
>
> "The Treasury rally will turn into a Treasury bear market once the dollar starts to roll over," said Don Coxe, global portfolio strategist with BMO Capital Markets in Chicago.

So what are the big risks that the cash is fleeing from?

One seems to be the fact that the emerging markets are "tanking". Their stock markets are down by 50% or more from values earlier this year. Investment dollars are fleeing these struggling markets to the relative safety of the US dollar.

Another risk is that the European banks seem to have lent heavily to the emerging markets. According to this U. K. Telegraph article, these debts are now likely to become a huge problem for European banks.

> The latest data from the Bank for International Settlements shows that Western European banks hold almost all the exposure to the emerging market bubble, now busting with spectacular effect.
>
> They account for three-quarters of the total $4.7 trillion (£2.96 trillion) in cross-border bank loans to Eastern Europe, Latin America and emerging Asia extended during the global credit boom – a sum that vastly exceeds the scale of both the US sub-prime and Alt-A debacles.

If this is the case, the Euro is not likely to be a good currency to be in. In fact, the situation starts to look very bleak.

Another reason the US dollar has been rising is because the co-ordinated interest cuts have reduced the profitability of the "carry trade". This was pointed out in the comments to my earlier post by Steve from Virginia. In the "carry trade", investors borrow the currency with low interest rates, and invest their money in countries with higher interest rates. With the smaller interest differential, this is becoming unwound. This unwind is affecting both the US dollar and the Japanese Yen. The effect is to increase the value of these currencies that are being unwound relative to other currencies. With a higher US dollar, the price of oil is lower to US consumers.

A closely related issue to the "unwind of the carry trade" is the fact that hedge funds are now being forced to sell their investments, either because of margin calls or because investors are leaving the funds. In my earlier post, I mentioned the fact that hedge funds were historically net long on oil, and sale of oil futures by the hedge funds would cause a downward pressure on oil prices. What I didn't consider was that the hedge funds were also selling foreign investments. The sale of these investments and return of the borrowed US dollars would also would also raise the level of the dollar. All of this raising of the level of the dollar has been acting to lower the price of oil. This is an article about the problem:

Dollar roars back as global debts are called in

> For six years the world has been borrowing dollars to bet on property, oil, metals, emerging markets, and every bubble in every corner of the globe.
>
> This has been the dollar "carry trade", conducted on a huge scale with high leverage. Now the process has reversed abruptly as debt deflation - or "deleveraging" - engulfs

> world markets. The dollars must be repaid. . .
>
> Hedge funds are 75pc dollar-based, regardless of where they come from. Many are now having to repatriate their dollars as margin calls, client withdrawls, and the need to slash risk forces them to cut leverage. The hedge fund industry had assets of $1.9 trillion at the peak of the bubble.

For the countries from whom investment is being withdrawn, the combination of the withdrawal of investment funds and the lower levels of their currencies have very negative impacts. At these lower currency levels, imports of all types, including oil, cost more. Also, the withdrawal of investment funds from these other countries harms the economies of these countries, further exacerbating the flight of currency from these countries.

I might also note that with reduced investment in these countries, it is likely that the demand for oil is dropping, or will soon start to drop. This reduced demand for oil, by itself, is likely to exert a downward impact on oil prices.

This destructive cycle will not continue indefinitely. At some point, central banks will sell US dollars, to try to get currencies more in sync. Hedge funds may begin to fail, as the value of the assets sold is insufficient to cover the debt supporting the assets. Also, it is not clear that the US can continue indefinitely as the source of safety. The US will be issuing many billion dollars of debt to pay for all of the bailouts. At some point, it may be difficult to find buyers for all the debt.

Alternatives to US Dollar

We are at this point hearing talk about the possibility of a replacement for the US dollar as the reserve currency. An official Chinese paper had this story in the last couple of days:

U.S. has plundered world wealth with dollar--China paper

> BEIJING, Oct 24 (Reuters) - The United States has plundered global wealth by exploiting the dollar's dominance, and the world urgently needs other currencies to take its place, a leading Chinese state newspaper said on Friday.
>
> The front-page commentary in the overseas edition of the People's Daily said that Asian and European countries should banish the U.S. dollar from their direct trade relations for a start, relying only on their own currencies.

This week-end, an Asian-European group held its biennial forum. One of the primary topics discussed was the financial crisis. According to this report,

> "I'm pleased to confirm a shared determination and commitment of Europe and Asia to work together," EU Commission President Jose Barroso said at a closing news conference.
>
> He said participants would use the statement as the basis of their approach at the Nov. 15 Washington summit of the 20 largest economies.

> Although short on details, the statement, adopted Friday, calls on the IMF and similar institutions to help stabilize struggling banks and shore up flagging share prices.

On Saturday, there was also a meeting of the Gulf Co-operation Council, talking about dealing with the financial crisis. The Gulf Co-operation Council has been working toward a common currency, effective January 1, 2010 (less than 15 months from now). According to the report of this weekend's meeting:

> The Gulf states, which are preparing for a single currency, emerged from the meeting with few public statements on how they would work together.
>
> Asked about the level of impact on Gulf economies, Qatari Minister of Finance Youssef Kamal said: “The likely effects of the global crisis, we can and we are dealing with through the measures we have already taken. The crisis proves how much we need a single currency and that a single central bank should be a supervisory body that will help in crisis hours.”

On November 15, there will be a G20 Summit meeting in Washington to deal with the financial crisis.

In the meantime, we can expect a lot of volatility in financial markets. The fluctuating value of the dollar is likely to continue to flow through to affect the price of oil. There are clearly supply and demand issues as well, but the volatility in the financial markets is likely to hide what would be "normal" trends.