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SPEAKING FREELY

## Killing the dollar in Iran

By Toni Straka

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Could the proposed Iranian oil bourse (IOB) become the catalyst for a significant blow to the influential position the US dollar enjoys? Manifold supply fears have driven the price of crude oil to its recent high of US\$67.10 - only a notch below its highest price in inflation-adjusted dollar terms. With the world facing a daily bill of roughly \$5.5 billion for crude oil at current price levels, it becomes apparent that sellers and purchasers of the black gold are looking into all ways that could lead to a financial improvement on their respective sides.

Non-US-dollar holders so far have been the victim of additional transaction costs in the oil trade. The necessary conversion of local currencies into oil-buying greenbacks can be considered a hidden tax, charged and enjoyed by the international banking sector. The IOB, by eliminating this transaction cost, will become

a factor that could unsettle the dollar's dominant position. While the worldwide bottleneck of inadequate refining facilities and partly dramatic declines in production - for example in the North Sea - are two factors that cannot be eliminated in the short term, there is one area left which could result in smiling faces of oil producers as well as most buyers.

Oil consumers are entangled in a web of supply fears that span the globe. In Venezuela, President Hugo Chavez threatens to divert oil supplies from the US to China, which faces severe gasoline and diesel shortages these days. Attacks on Iraqi oil installations have slowed exports there. Ecuador's oil industry is still recovering from a strike, while Nigerian oil companies are in the middle of efforts to avoid a strike there.

Until now, oil has been solely priced, traded and paid for in the greenback on markets in both London and New York. But monthly worldwide oil revenues of over \$110 billion (on a 20-trading-day basis) - a third of which ends up with OPEC (Organization of the Petroleum Exporting Countries) members - raise the question of what happens to these cash mountains. According to the most recent data from the US Treasury Department, OPEC members have parked only a skimpy \$120 billion in direct dollar holdings, which are almost equally split between equities and American debt paper. This is a clear indication that oil producers are investing their windfalls elsewhere. The yield spread between US and EU debt papers in favor of the EU is another hint where the petrodollars might be heading.

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Especially in the case of Iran, it does not make sense to accept dollars only for its much-desired commodity. Given that Iran is seen as a hostile country by the current US administration for its intention to build its own nuclear reactors, one wonders whether the new IOB will not try to attract buyers other than Americans. Iran has recently announced that the new oil exchange will start up its computers in March 2006.

The proposal to set up a petroleum bourse was first voiced in Iran's development plan for 2000-2005. Last July, Heydar Mostakhdemin-Hosseini, who heads the board of directors of the Iranian Stock Exchange council, said authorities had agreed in principle to the establishment of the IOB, where petrochemicals, crude oil and oil and gas products will be traded. The oil exchange would strive to make Iran the main hub for oil deals in the region and most deals will be conducted via the Internet. Experts from London's International Petroleum Exchange (IPE) and the New York Mercantile Exchange (NYMEX) have reportedly confirmed the feasibility of the project.

The IOB can count on two sharp arrows in its holster. It can - and probably will - lure European buyers with oil prices quoted in euros, saving them dollar transaction costs. And it can strike barter deals with oil-hungry giants like China and India who have a lot of products and commodities to offer. One doubts whether American hamburgers and legal services will be considered adequate collateral for the world's most after-sought resource.

#### **Worse than an Iranian nuclear attack?**

Weaned off the almighty commodity, the US dollar can have a deeper impact on the US economy than a direct nuclear attack by Iran. The permanent demand for dollar-denominated paper stems substantially from the fact that until now almost all resources of the world are quoted in it. While this led to the eurodollar (US dollar-denominated deposits at foreign banks or foreign branches of American banks) market in the 1970s, the new terms of trade could ring in the demise of the dollar as the premier reserve currency.

With the world economy depending so much on oil, the black gold itself can be seen as a reserve currency that will be handed out against only the best collateral in the future. Last month, the Federal Reserve Bank of San Francisco published a paper about the progress of the diversification of central banks' reserves around the world. It concluded that the dollar's position is on the decline in many countries. China, the new industrial giant, has officially declared that it will diversify a part of its forex holdings into oil by building a strategic petroleum reserve. Construction of storage tanks has begun this year and will take several years until completion. China has not yet said how many barrels of oil it wants to store. The implications for the oil market can only be guessed as China wants to use its future reserves to smooth out spikes in oil price.

Iran holds a strong hand as the No 2 producer of crude behind Saudi Arabia, pumping 5% of the world's oil demand. Politicians there will also keep in mind that dollar deposits might become a burden in the future, if the US steps up its current war of words to the level of economic sanctions in the attempt to halt construction of Iran's nuclear power plants. Money in the bank does not help when you have no access to it. Substituting Iran's domestic oil demand partly with nuclear power will place the country in a win-win situation. Cheaper nuclear energy and increases in oil exports from the current level of roughly 2.5 million barrels a day will result in a profitable equation for Iran.

Only one major actor stands to lose from a change in the current status quo: the US, which with less than 5% of the global population, consumes roughly one third of global oil production. Oil in euros would benefit millions more in the EU and its trading partners, though. And it would loosen the grip the US has on OPEC members. Thinking of the rapid growth of hostilities

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between the US and Arab nations in recent years, a renunciation of the dollar appears to be more than just an Arab daydream.

As this development poses a very real danger to the superior status of the greenback and the interests of the US, the "president of war" can be expected to take a strong line against the winds blowing from the Middle East. One may be reminded that Saddam Hussein had entered into discreet talks with the EU, proposing to sell his oil for euros. That was in the year before the first oil war of this century.

The IOB could help the euro to become the interim primary reserve currency before China and India rise to the first two slots in the global economic ranking in the next few decades. A decline of the dollar's position in oil trading might also open the floodgates in other commodity markets where the dollar is the medium of exchange but where the US has only a minority market share. A global economy driven by tough efficiency demands in the light of thin profit margins almost everywhere is a good primer for accounting changes in other commodity markets as well. This process could begin in resources like steel and energy and spread to all other resources that are marketed globally. The world outside the US has a lot to gain from it.

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