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The Dollar-Oil Link

Would oil cost less if priced in euros?

BY MARTIN FELDSTEIN

The rapid rise in the price of oil and the sharp depreciation of the dollar are two of the most noteworthy developments of the past year. The price of oil has increased by 85 percent over the past twelve months, from $65 a barrel to [more than] $120. During the same period, the dollar fell by 15 percent relative to the euro and 12 percent against the yen. To many observers, the combination of a falling dollar and a rise in oil prices appears to be more than a coincidence.

But what is the link between the two? Would the price of oil have increased less if oil were priced in euros instead of dollars? Did the dollar's fall cause the price of oil to rise? And how did the rise in the price of oil affect the dollar's movement?

In reality, the currency in which oil is priced would have no significant or sustained effect on the price of oil.

Because the oil market is global, with its price in different places virtually identical, the price reflects both total world demand for oil and total supply by all of the oil-producing countries. The primary demand for oil is as a transport fuel, with lesser amounts used for heating, energy, and as inputs for petrochemical industries like plastics. The increasing demand for oil from all countries, but particularly from rapidly growing emerging-market countries like China and India, has therefore been, and will continue to be, an important force pushing up the global price.

The thinking behind the question of whether oil would cost less today if it were priced in euros seems to be that, since the dollar has fallen relative to the euro, this would have contained the rise in the price of oil. In reality, the currency in which oil is priced would have no significant or sustained effect on the price of oil when translated into dollars, euros, yen, or any other currency.

Here is why. The market is now in equilibrium with the price of oil at $120. That translates into €75 at the current exchange rate of around $1.60 per euro. If it were agreed that oil would instead be priced in euros, the quoted market-equilibrating price would still be €75 and therefore $120. Any lower price in euros would cause excess global demand for oil, while a price above €75 would not create enough demand to absorb all of the oil that producers wanted to sell at that price.

Of course, the rate of increase of the price of oil in euros during the past year was lower than the rate of increase in dollars. The euro price of oil in May 2007 was €48, or 56 percent below its current price. But that would be true even if oil had been priced in euros.

The coincidence of the dollar decline and the rise in the oil price suggests to many observers that the dollar's decline caused the rise in the price of oil. That is only true to the extent that we think about the price of oil in dollars, since the dollar has fallen relative to other major currencies. But if the dollar-euro exchange rate had remained at the same level that it was last May, the dollar price of oil would have increased less.

The key point here is that the euro price of oil would be the same as it is today. And the dollar price of oil would have gone up 56 percent. The only effect of the dollar's decline is to change the price in dollars relative to the price in euros and other currencies.

The high and rising price of oil does, however, contribute to the decline of the dollar, because the increasing cost of oil imports widens the United States' trade deficit. In 2007, the United States spent $331 billion on oil imports, which was 47 percent of the U.S. trade deficit of $708 billion dollars. If the price of oil had remained at $65 a barrel, the cost of the same volume of imports would have been only $179 billion, and the trade deficit would have been one-fifth lower.

The dollar is declining because only a more competitive dollar can shrink the U.S. trade deficit to a sustainable level. Thus, as rising global demand pushes oil prices higher in the years ahead, it will become more difficult to shrink America's trade deficit, inducing more rapid dollar depreciation. ◆

Martin Feldstein, a professor of economics at Harvard, was formerly Chairman of President Reagan's Council of Economic Advisors.