Foreign Exchange by William Engdahl

More dollar shocks ahead

Behind the dollar's rise are "accidents" in North Sea oil production, which drove oil prices sky-high.

Contrary to all expectations, the dollar has been booming against the two other major world trading currencies, the Japanese yen and German deutschemark. How could this be, when only hours after the election victory of George Bush, dollar traders scrambled to dump the currency, because of what one Swiss bank calls "budget policy pessimism"?

In the first weeks of January, a sea of dollar "buy" orders began to appear on markets. Nothing concrete had changed from one month earlier in the key international economies. The relative interest rate advantage for a Tokyo bank to speculate in dollar paper had been at the highest in four years, but that had been so for months. The difference can be summed up in one word: oil.

Petroleum is the largest commodity traded internationally. Since 1975, OPEC producers have had a rigid agreement to accommodate, insisting that all sales of their crude be struck in dollars. This rigid policy has cost OPEC dearly, as the dollar collapses or soars on floating exchange rate markets. Under this regime, if the nominal price of oil rises by one-third in a matter of weeks, that means West Germany, for example, must sell deutschemarks for dollars to pay for the "black gold."

Now, over the past decade there has been a little-noticed transformation of world oil pricing. It is not OPEC which today determines the effective international price, but commodity futures or forward markets in London and, to an extent, in New York's Nymex. The most important crude for daily price movement is North Sea Brent, used in most West German and North European refineries.

Suddenly, oil prices started to shoot upward in January. This, only days after reports of OPEC "surplus" production of 23 million barrels/day in December, with estimates that January OPEC output was still at least 1.5 million barrels/day above its agreed 18.5 million ceiling struck only late November to prevent a collapse of prices below $10 per barrel. The key to the mysterious rise lay in the North Sea. Since the first of December, Brent crude has soared from $14/bbl to nearly $17 by Feb. 1, a more than 20% hike in eight weeks.

In the first days of January, North Sea oil was hit by a bizarre string of disasters. By Jan. 5, fully 25% of North Sea production had been shut down temporarily, owing to accidents at a number of major offshore production platforms owned by Shell, Occidental, and Texaco. "The word here in London," noted one trading source, "is that the recent drop in North Sea oil output is not an accident. It was a deliberate move to push oil prices higher, and more importantly, the dollar with it. It has forced the Germans to raise their interest rates in defense and created an uncertain climate for long-term investment in Germany." Panic buying for scarce Brent carried the prices up throughout January.

I don't have any spies on the Piper Alpha or other North Sea platforms, but a sharp rise of the dollar began in the same early January period, and the rise caught all major trading centers off guard. The dollar began to resume its rise against the mark, so much so that by Jan. 19, the German Bundesbank, coordinated with the French, Swiss, Austrian, Dutch, and Belgian central banks, raised official interest rates by a hefty .5% to discourage further deutschemark dumping by "hot money" speculators. That move did little to dampen the dollar's strength, as the seven largest industrial states prepared for the Feb. 3 Washington meeting of the Group of Seven.

It's too early to say, but clearly there is increasing alarm, if not anger, at the short-term manipulations with which the new administration appears to be managing the perilous situation of international financial market confidence. Beginning 1981, U.S. Treasury Secretary Don Regan, fresh from Wall Street's Merrill Lynch, ensured, in tandem with then-Fed chief Paul Volcker, that the dollar would soar through the ceiling, with annual increases of some 20% in the early 1980s against the deutschemark and yen, in order to suck in staggering volumes of world capital liquidity to finance federal budget deficits.

By March 1985, that rise abruptly began to stop as new Treasury chief James Baker coordinated a massive dollar intervention from worried G-7 allies. That began an equally stunning downslide of the world's most important international reserve currency. While it helped U.S. exports revive by 1987 and 1988, such "single-issue" gimmicks ravaged entire sectors of world production.

Are we now on the brink of new shocks and manipulations to force further concessions from West European and Japanese coffers, to prop up a bankrupt U.S. policy? There are already signs that certain "allies" are not so willing to assist this time around.