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Membership and aims

OPEC is a permanent, intergovernmental Organization, established in Baghdad, September 10–14, 1960, by IR Iran, Iraq, Kuwait, Saudi Arabia and Venezuela. Its objective is to coordinate and unify petroleum policies among Member Countries, in order to secure fair and stable prices for petroleum producers; an efficient, economic and regular supply of petroleum to consuming nations; and a fair return on capital to those investing in the industry.

The Organization comprises the five Founding Members and six other Full Members: Qatar (joined in 1961); Indonesia (1962); SP Libyan AJ (1962); United Arab Emirates (Abu Dhabi, 1967); Algeria (1969); and Nigeria (1971). Ecuador joined the Organization in 1973 and left in 1992; Gabon joined in 1975 and left in 1995.

Web site

Visit the OPEC Web site for the latest news and information about the Organization and its Member Countries. The URL is

http://www.opec.org

This month's cover ...

shows an oil facility offshore the SP Libyan AJ, which has just been voted the world's top oil and gas exploration hotspot by a UK consultancy (see Newsline beginning on page 15).
Photo courtesy Libyan NOC.

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Paying for oil: will the euro rise to challenge the dollar's supremacy?

The adoption of the euro as legal tender across most of Western Europe has refocused attention on whether it might one day rival the dollar, especially in the oil market. The Head of OPEC's Petroleum Market Analysis Department, ***Javad Yarjani,*** ** looks at the future possibilities.*

Europe's single currency, the euro, has been a reality since 1999. Starting this year, it was adopted as legal tender in the 12 countries of the euro-zone, and the old currencies were phased out. Today, more than 300 million people use the euro, which signals a positive step for European economic integration.

Indeed, the 12 European Union (EU) nations that form the euro-zone deserve to be congratulated on the successful transition from their twelve different national currencies to the euro. Everyone was pleasantly surprised at how smoothly and swiftly the switchover took place, considering it involved the largest currency swap undertaken in history.

The question that now comes to mind is whether the euro will establish itself in world financial markets, thus challenging the supremacy of the US dollar, and consequently trigger a change in the dollar's dominance in oil markets.

As we all know, the mighty dollar has reigned supreme since 1945, and in the last few years has even gained more ground with the economic dominance of the United States, a situation that may not change in the near future. By the late 1990s, more than four-fifths of all foreign exchange transactions, and half of all world exports, were denominated in dollars.

In addition, the US currency accounts for about two-thirds of all official exchange reserves. The world's dependency on US dollars to pay for trade has seen countries bound to dollar reserves, which are disproportionately higher than America's share in global output. The share of the dollar in the denomination of world trade is also much higher than the share of the USA in world trade.

Nevertheless, it is worthwhile to note that in the long run, the euro is not at such a disadvantage versus the dollar when one compares the relative sizes of the economies involved, especially given the EU enlargement plans. Moreover, the euro-zone has a bigger share of global trade than the USA, and while the latter has a huge current account deficit, the euro area has a more balanced external accounts position. One of the more compelling arguments for keeping oil pricing and payments in dollars has been that the US remains a large importer of oil, despite being a substantial crude producer itself. However, looking at the statistics of crude oil exports, one notes that the euro-zone is an even larger importer of oil and petroleum products than the USA.

While the euro has the potential to be a viable competitor and possible alternative to the dollar in international financial and commodity markets in the medium to long term, its external weakness to date has meant it has been unable to gain inroads in the last two years.

From the time the euro was floated in January 1999, the currency drifted downwards, losing about 30 per cent of its initial value against the dollar by October 2000. It has since regained some of this lost ground, but is still far removed from parity with the dollar and even further removed from its starting value.

Many reasons have been suggested to explain the weakness of the euro in the last two years, but they all overlook the fact that a fledgling currency needs time to establish itself and gain credibility even under the best internal and external conditions.

There is of course also the issue of the economic diversity within the countries of the EU to consider. Many fundamental structural issues need to be addressed and many steps taken in order to harmonise the economies of the countries within the euro-zone. One can appreciate that the European Central Bank has a serious challenge, and indeed a difficult task, to adopt one policy to fit all countries facing different immediate requirements and various structural problems. Thus, it could well be that the euro will be subjected for quite some time to more scrutiny than the dollar, because of the diversity of its region, which may give the greenback a temporary edge over its new competitor.

* *Based on the speech delivered by Mr Yarjani on behalf of OPEC's Secretary General,* ***Dr Alí Rodríguez Araque,*** *to the seminar on 'The international role of the euro' in Oviedo, Spain, April 14, 2002. The logo on these pages symbolizes the Spanish presidency of the European Union in the first half of 2002.*

It must also be recalled that the links between crude oil and the dollar are deeply embedded in economics, politics and trading traditions. Naturally, the trading of oil in dollars has served the interests of the USA, giving it an immediate advantage over other countries because it carries no currency exchange risk. For most other oil consumers around the world, the pricing and payment of crude in dollars increases the risk for these countries because of currency fluctuations. When the dollar rises against other currencies, the price of oil is more expensive for the rest of the world, thus potentially increasing inflation in these countries.

Despite this, it is worth examining some of the issues surrounding the denomination of payments for oil, with the euro in mind. Firstly, it is good to note that oil producers and big crude consumers, and importers from non-dollar areas, like the EU, have common interests. They are both interested not only in stability of oil prices and a reduction in price volatility but also in stable currencies. In other words, they would like to minimize oil price risk and currency risk. Producers and consumers may differ as to the desired oil price level, although I think they are probably not so far apart on that question, but they would both easily agree that currency risk is undesirable.

Removing currency risk

From the EU's point of view, it is clear that Europe would prefer to see payments for oil shift from the dollar to the euro, which effectively removes the currency risk. It would also increase the demand for the euro and thus help to raise its value. Moreover, since oil is such an important commodity in global trade, in terms of value, if the pricing of oil were to shift to the euro, it could provide a boost to the global acceptability of the single currency. There are also very strong trade links between OPEC Members and the euro-zone, with more than 45 per cent of total merchandise imports of OPEC Members coming from the countries of the euro-zone, while OPEC Members are major suppliers of oil and crude oil products to Europe.

From the point of view of producers, OPEC Members are mainly interested in a currency that provides a stable store of value for their revenues. At various points in time since the early 1970s, oil producers have discussed the question of what currency oil payments should be denominated in, especially in periods when the dollar has been weak.

Opinions have tended to be wide and ranging, depending on the strategic and trade alliances certain OPEC Members have with particular trade blocs. But in recent years, the strength of the dollar has helped OPEC in cushioning some of the erosion in the value of the oil barrel.

Now let us turn to two main issues. One relates to the denomination of crude oil pricing in dollars and the other to the choice of currency for payments for oil. Oil is a globally traded commodity and the present pricing system is one in which OPEC crude oil prices are calculated based on formulas derived from marker crudes like Brent, WTI or Dubai, all of which are denominated in dollars in international oil markets. The whole system of global oil trading and hedging is built around the dollar, and there appears to be little chance of change to another currency in the near future.

'Producers and consumers are interested not only in stable oil prices, but also in stable currencies.'

Of major importance to the ultimate success of the euro, in terms of oil pricing, will be if Western Europe's two major oil producers — the United Kingdom and Norway — join the single currency. Naturally, the future integration of these two countries into the euro-zone and Europe will be important considering they are the region's two major oil producers in the North Sea, which is home to the international crude oil benchmark, Brent. This might create a momentum to shift the oil pricing system to euros.

However, from today's perspective, even after the UK joins the single currency, there would seem to be little incentive for London's International Petroleum Exchange (IPE), where Brent is traded, to switch its Brent crude oil and gas oil contracts to euros, since both are traded internationally and the dollar is at the centre of a complex global oil trading and hedging system. There is more chance that the IPE will consider changing its natural gas and power contracts to euros.

Product price disparities

With respect to petroleum products, it appears that here the euro may make some inroads. Within the euro-zone, petroleum products to the final consumer are now sold in euros, highlighting the disparities in final product prices within the EU. The only spot market that has so far adopted the euro is the Hamburg barge market, which previously used Deutschmarks.

So what is the OPEC position on this critical question? Can the Organization consider switching its crude oil pricing from dollars to euros? Or will a basket of currencies be used?

Because crude oil contracts are currently traded in dollars, and the prices of OPEC crudes are determined by using complex formulas derived from marker crudes, such as Brent and WTI, there is not much the Organization can do unilaterally until, and unless, there is a switch of denomination in these markets.

OPEC has no control over the quotations of these marker crudes, whereas in the past, the Organization did in fact set the official selling prices. That has all changed with the introduction of market-related prices which saw the system change from a seller's to a buyer's market, or at least where market forces now dictate prices. Moreover, the entire infrastructure of the oil market has been based around the dollar, and that will be hard to displace. However, as previously mentioned, a lot depends on Britain and Norway in determining what their level of EU integration will be, and whether their marker crude, Brent, could be traded in euros.

The other question, of course, is whether importers can pay for oil in another currency than the dollar. The EU would like to pay for oil in euros. The question is now whether oil producers

would be willing to accept euros instead of dollars and who carries the implied currency risk, since prices are set in dollars but payment is made in euros.

If OPEC Members were to accept the denomination of oil bills in euros, it would be desirable if the buyers would carry some of the currency risk, or alternatively if both the seller and the buyer would perhaps share the risk. Currency clauses could be introduced in sales contracts that specify these issues. The use of financial hedging tools to manage the currency risk could be envisaged, with the cost of hedging shared between buyer and seller.

In the short-term, OPEC Members, with possibly a few exceptions, are expected to continue to accept payment in dollars. Nevertheless, OPEC will not discount entirely the possibility of adopting euro pricing and payments in the future. The Organization, like many other financial houses at present, is also assessing how the euro will settle into its life as a new currency. The critical question for market players is the overall value and stability of the euro, and whether other countries within the Union will adopt the single currency.

Varying preferences

It must be remembered that OPEC is comprised of eleven sovereign Member Countries, all with varying preferences as to the denomination of oil bills. These preferences depend on which markets in the world the OPEC crude is destined for and from which countries OPEC imports goods and services.

For example, countries that trade mainly with Asia or North America would gain little advantage by pricing oil in euros. Equally, countries with large assets in dollars would have little interest in changing the current system. Alternatively, there are other OPEC Members that conduct most of their trade with Europe, which would be more likely to favour pricing in euros.

It is quite possible that as the bilateral trade increases between the Middle East and the European Union, it could be feasible to price oil in euros, considering Europe is the main economic partner of that region. This would foster further ties between these trading blocs by increasing commercial exchange, and by helping attract much-needed European investment to the Middle East.

In the long term, perhaps one question that comes to mind is could a dual system operate simultaneously? Could one pricing system apply to the western hemisphere in dollars and for the rest of the world in euros? This will remain the test for the euro, should the currency gain ground in the market of oil transactions.

An increased level of international trade, if undertaken in euros, will help determine the value of the currency. Essentially, increased trade in euros, associated with a rise in the value of the currency, would also encourage people to view it as a safe bet in terms of savings, or as a store of value. For the euro to emerge as a serious competitor to the US dollar, it would need to replace or parallel the dollar as the currency of choice for hard currency reserves. In addition, it will be the financial and trading institutions that will also determine the speed of the euro's integration into world markets.

The global competition between the euro and the dollar will evolve in the future depending on many factors. Essentially, a strong, and therefore attractive euro to hold, will ultimately depend on a robust and stable European political and economic system. The more integrated Europe becomes, the greater the likelihood that it will play an increasingly active role in world economic and political affairs and the more confidence its currency will inspire.

As the share of reserves held by central banks begins to reflect the share of the euro in world trade, there will be a chance for the single currency to gain ground in the denomination of commodity trading as well as being used as a means of payments and a store of value.

However, one should also be aware that the dollar now benefits from its status as an incumbent currency and that the forces of entropy are expected to lend support to the US currency versus the euro. This was the case for the pound sterling long after the UK had lost its economic supremacy.

Moreover, confidence in the US economy remains unrivalled, despite the recent slowdown. This level of optimism could mean that capital and investment flows to America will remain strong, from Europe as well.

Projecting ahead, the largest proportion of future incremental oil growth will come from developing countries as they realise their developmental goals. The projected economic growth in developing countries will be oil-intensive. This fact may have a bearing on the currency, or currencies, that OPEC Members may individually or collectively choose for future currency denomination of their oil bills, depending on the preferences of both buyers and sellers.

One last point deserves to be mentioned. We are experiencing a phase in the oil market where OPEC and other market players are revisiting the issue of the marker crudes. Serious thinking is going into seeking alternatives to the present marker crudes that would be more representative and that would reflect the reality of the underlying physical market.

In the coming years the present marker crudes may become less and less representative and more liable to manipulation and squeezes due to smaller volumes of production. While it is too early to talk of alternatives with any degree of precision and still even earlier to speculate about the currency in which it will be denominated, it is good to remember that some changes in the way we conduct the oil business will become inevitable in the coming years and we must prepare for them.

In these interesting times, the possibilities that may result from the launching of the euro remain to be seen. Essentially, OPEC is concerned with delivering fair and stable prices to consumers. The underlying imbalances in the existing system as to the denomination of oil bills could be ironed out partially with the inclusion of other currencies in the trade of oil.

Ultimately, for every scenario that may emerge, there is a note of caution, and that is oil market stability should not be jeopardised or threatened in any way. The existing oil pricing and payments system, despite its known deficiencies, is a system that functions smoothly.

Should the euro challenge the dollar in strength, likely giving it a greater role in the international oil market and payments for oil, it could be that a system may emerge which benefits more countries in the long term. Perhaps with increased European integration and a strong European economy, this may become a reality.