A Looming Monetary Collision:
Oil, the dollar and the euro

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Despite the vigorous debate in the United States and around the world on the many difficult questions associated with a war on Iraq, one topic is notable for its absence: the possible effect of a war on the stability of the U.S. dollar and the global financial system. It was the same during the Vietnam era, when the debate all but bypassed the severe turbulence in the global financial system that that war precipitated. This time the consequences could be much worse because there is an even greater risk of a collapse of the dollar due to the vulnerabilities that were created then.

There are numerous reasons for the risk of monetary chaos today. The emergence of the euro at a time of military and political turbulence is among them. Periods of crisis in capitalism have often been marked by monetary crises, including competition between the currencies of rival powers. In the nineteenth century, up to World War I, the British pound reined supreme as the currency of the dominant imperialist power. There was a period of competition, collapse and chaos between World War I and World War II. The countries that lost the war and their colonies saw their currencies fall apart. The German mark collapsed. Currencies were taken off the gold standard and put back on and taken off. Currency turbulence, debt crises, and questions relating to World War I reparations were crucial factors in the rise of Nazism in Germany. The gold standard even figured in a coup plot in the United States in 1933.[3]

The current risks are rooted in the basic changes that have taken place during the last three decades in the monetary system that was introduced at the end of World War II. So some history is in order.

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[3] Wall Street was so concerned that President Franklin Roosevelt would debase the U.S. dollar by engaging in expansive and inflationary public sector spending that they wanted to rein him in by forcing the United States on to a gold standard. Some of the captains of finance and industry even plotted a coup in 1933 to make FDR into a figurehead so they could run things from behind the scenes. Part of the idea was to impose a gold standard. Their selected military man to lead the coup, retired marine general and hero, Smedley Butler, refused and went to the press and Congress with the information. A brief account, with sources, "An American Coup d'État?" by Clayton E. Cramer, is available at http://home.iprimus.com.au/korob/fdtcards/Butler.html. A detailed account can be found in Jules Archer, *The Plot to Seize the White House*. New York: Hawthorn Books, 1973.

At the end of World War II, all major powers, victors and vanquished alike, except the United States, were in various states of destruction and debt. They were exhausted by war and in need of external assistance to rebuild. Britain and France were also under pressure from independence movements in the colonies. Only the United States came out of the war richer and stronger. It possessed a monopoly of nuclear weapons. It was the world's largest creditor and had half the world's economic output. It exported both oil and capital. It had three-quarters of all the central bank gold in the world.

Looking to the post-war world, the major capitalist powers among the Allies agreed, during a 1944 conference at Bretton Woods, New Hampshire, to a U.S. plan to make the U.S. dollar the anchor of the world's post-war monetary system. The basis of this plan was that U.S. dollars would be, literally, as good as gold. The United States promised to exchange them at a fixed rate of $35 per ounce of gold. The promise was based on a large store of gold at Fort Knox, Kentucky, and the immense financial strength of the United States. In return, the U.S. got the right to print the global reserve money. The world was willing to hold dollars because they represented gold at a constant price and because they were issued by the world's wealthiest and most powerful country.

By 1973, the global monetary situation had changed dramatically. The world has seen repeated monetary turbulence since then. These crises are unlikely to be eliminated until a new and more equitable and stable system is put into place to reflect the more diffuse economic power in the world relative to the end of World War II. Let's take a look at its evolution.

As Western Europe rose from the ashes of war in the two decades after 1945, the currencies of European countries regained local stability. At about the same time, in 1964, the U.S. Congress passed the Gulf of Tonkin resolution that led to a large-scale war in Vietnam. President Johnson's "guns and butter" policy during that war set off serious global inflation – because inflation in the U.S. currency also created inflation in global prices. This undermined confidence in the dollar and Europeans began to turn in their dollars for gold at faster rates. It soon became unsustainable. In 1971 President Nixon devalued the dollar by 20 percent and suspended gold convertibility. He completely de-linked it from gold in early 1973, inaugurating the present era of floating currency exchange rates. Then came the October 1973 Arab-Israeli war, the Arab oil embargo, and the steep rise in oil prices. This coupled energy insecurities to financial ones.

Despite its de-linking from gold, the dollar continued to reign as the supreme global currency for a number of reasons, including the unequalled size of the U.S. economy and the lack of an alternative global currency. But the readiness of the world to hold dollars in increasing amounts also had another reason, which is a principal source of the U.S. monetary vulnerability in the Persian Gulf today. The Organization of Petroleum Exporting Countries (OPEC), whose leaders were Iran, Saudi Arabia, and Venezuela, decided to maintain its policy of pricing oil in U.S. dollars. That, in effect, made the oil under the sands of the Persian Gulf countries, which have two-thirds of the world's proven oil reserves, the new Fort Knox of the dollar.

The Shah of Iran was the United States' chosen guardian of this new Fort Knox; he proved to be a shaky one. With no possibility of countering the Shah's repression of dissent but in the mosques, the Iranian people angrily overthrew the Shah in 1979, in an Islamic revolution directed as much against the United States as against him. Oil prices soared to $40 a barrel. The dollar sank to post-war lows against West European currencies. Only draconian increases in interest rates imposed by Federal Reserve chairman Paul Volcker, President Carter's emergency appointee to that post, the saved the dollar.

The price was high. Unemployment and inflation rose in the United States, sending the sum of the two – picturesquely dubbed as the "misery index" by then-presidential candidate Ronald Reagan -- to post-war highs. Abroad, interest payments on many foreign debts increased in step with U.S. interest rates, precipitating a debt crisis across the developing world, starting with Mexico in 1982, which could have caused the collapse of major U.S. banks. The debt chart (Figure 1) shows that even some oil exporting countries that benefited from higher oil prices fell into debt partly as a result of global inflation (represented by the U.S. consumer price index in the chart) and rising interest rates. Excessive borrowing, partly caused by global inflation, was another contributory factor.

A full-blown debt crisis began in 1982, with a near-default by Mexico, an oil exporter. Only a wave of IMF-dictated restructurings saved the exposed multinational banks. But mechanical application of IMF "prescriptions" has left the working people of many debt-ridden much worse off -- with high unemployment, lower real wages, and tattered social safety nets. Third World debt has increased almost five fold (in current dollars) since 1982.

The problems of the dollar were obscured by a number of factors in the 1980s and 1990s. Falling oil prices, the collapse of the Soviet Union, the apparent establishment of unchallenged U.S. military supremacy, the willingness of foreigners to invest large sums of money in the United States, the unfolding of the Oslo peace process in Israel/Palestine and spectacular increases in stock prices in the 1990s put the United States on top of the world. But the vulnerabilities were accumulating nonetheless. They are now acute, and, in many ways, the situation is more precarious than in 1979:

1. Economic power is much more diffuse than at the end of World War II. The U.S. share of global product is about 25 percent, which is half the share it had in 1945.
2. The United States imports about 60 percent of its oil requirements, up from 30 to 40 percent during the 1970s.
3. U.S. trade deficits are now immense – well over $400 billion in 2002 and running at an even higher rate in 2003. In a falling stock market, foreigners are less inclined to finance the huge trade deficits that have been part of the U.S. economic binge. The prospects for large inflows of European money to finance the U.S. trade deficit are murky, at best. Foreign investment has been declining, and so has the U.S. dollar. U.S. foreign debt, already the largest in the world, is set to grow.

4. The one long-term bright spot from the 1990s, U.S. budget surpluses that emerged late in that decade, has now disappeared in a sea of red ink.
5. Gross U.S. federal debt is now over $6 trillion, or about 60 percent of GDP, compared to fewer than one trillion dollars and about 33 percent of GDP in 1980.
6. Perhaps most important, the euro has now emerged as a credible alternative, and hence a possible competitor, to the dollar. Initial questions about its stability when it was introduced as a unit of account in 1999 and quickly lost ground to the dollar, have dissipated. The euro rose in value by about 20 percent relative to the dollar in 2002. It was first issued as a currency that people could use in everyday transactions on January 1, 2002. The euro-zone is comparable in economic size to the United States.

Petroleum resource issues must be seen in the context of this much weaker relative U.S. financial, economic, and resource position. U.S. physical control over Persian Gulf oil resources, which had been re-established somewhat after the 1991 Gulf War, began eroding significantly in the mid-1990s. The long-term presence of U.S. forces in Saudi Arabia, with the world's larges petroleum reserves, had been challenged violently by Osama bin Laden's al Qaeda. There were two attacks on U.S. forces stationed in Saudi Arabia in the mid-1990s. These occurred in the context of rising popular Saudi antagonism to their presence. The Saudi government refused to collaborate fully with the U.S. in the investigation of the attacks on U.S. soldiers in Saudi Arabia. Low oil prices created domestic political weakness for the Saudi government, widely viewed as corrupt. Yet, the U.S. military presence in Saudi Arabia is dependent on that unpopular government.

The terrorist 1998 attacks on the U.S. embassies in Kenya and Tanzania raised the insecurity of the U.S. presence in Saudi Arabia to new levels. Saudi Arabia continued funding and supporting the Taliban, which was sheltering Osama bin Laden, who, like Saddam Hussein, was a U.S. ally in the 1980s. (1998 was also the year in which the introduction of the euro on January 1, 1999 became a certainty.)

The U.S. seems to have decided that the ousting of Saddam Hussein was a goal in 1998, independent of the results of the disarmament of Iraq that the United Nations inspectors were achieving. By that time, the physical infrastructure of the Iraqi nuclear weapons program had been destroyed by inspections. But the Clinton administration's response was to say that Saddam Hussein was a dictator and that the United States should work with the Iraqi opposition to get rid of him. Iraq reduced its cooperation with inspectors in the latter half of 1998. The U.S. and Britain escalated their threats of war. Caught in the escalating crisis, the U.N. inspectors left Iraq in November 1998. The United States and Britain started bombing Iraq in December, claiming they needed no new Security Council authorization to do so.

Disarmament of Iraq is an implausible war aim. It is eminently clear that the disarmament of Iraq is better and more thoroughly accomplished through inspections, as the recent as well as the 1991-1998 inspections have shown. By contrast, there no evidence that a war on Iraq could produce disarmament. The bombing of vast sections of

Iraq since 1998 and four years without inspections created more questions and uncertainties about Iraqi stocks of weapons of mass destruction and no disarmament relating to them. Moreover, an invasion may actually result in an increase in clandestine proliferation of chemical or biological weapons. In sum the U.S. linking of war, regime change, and disarmament of Iraq is not persuasive, to say the least.

The links of the U.S. regime change policy to other goals are more plausible. The U.S. determination of occupy Iraq may have three main goals related to the control of oil:

1. To control physically the country with the second largest oil reserves in the world – more than 100 billion barrels – in view of the increasing opposition to the U.S. military presence in Saudi Arabia.[4]
2. To establish a long-term military presence in the Persian Gulf region so as to control the principal external source of oil supplies for Western Europe and China (which became an oil importer in the 1990s). This would fit into the U.S. goal of preventing either of them from emerging as global rivals, first suggested in a Pentagon draft document under the first President Bush, when Dick Cheney was Secretary of Defense.[5]
3. To ensure, by physical occupation of the second largest oil reserves in the world and by a military presence in the Persian Gulf region that could enable rapid occupation of Saudi oil fields, that the price of oil would remain denominated in dollars.

The threat of conversion of oil prices to euros was demonstrated by Saddam Hussein in the fall of 2000. At that time, he demanded and got permission from the United Nations to be paid for oil in euros. But his grandstanding about the euro had no practical economic effect because Iraq was not in a position to change OPEC oil pricing policy.

A U.S. invasion and occupation of Iraq might create a monetary result more to the liking of Saddam Hussein than President Bush. That is because the worldwide, including European and Arab, opposition to a U.S.-led war in the context of a rising euro and U.S. economic vulnerabilities could create severe pressures on Saudi Arabia and others to change their oil pricing strategy away from dollars. Iran, which has been named as part of the "axis of evil" by the Bush administration, might also want such a change. A switch to euros has been considered in Russia. Public pressure and/or a falling dollar might also force OPEC countries generally as well as Britain or Norway to consider it.

There might be monetary chaos if key countries start denominating their oil in euros, or if OPEC changes its oil pricing strategy to euros, in the midst of a global crisis. Countries and individuals currently tend to hold their foreign reserves in dollars, in part because dollars buy oil. A dumping of dollars arising from even a partial switch to oil pricing in euros could cause a sudden and steep decline in the value of the dollar. In that context, countries and corporations may decide to convert their monetary reserves, now held

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[4] Michael Klare, "Oiling the Wheels of War," *The Nation*, October 7, 2002.
[5] "Excerpts from the Pentagon's Plan: 'Prevent the Re-Emergence of a New Rival'," *New York Times*, March 8, 1992.

mostly in dollars, to euros and to commodities such as gold or oil. In 1979, the sharp decline of the dollar relative to European currencies occurred in parallel with skyrocketing prices of oil and gold.

It is entirely possible that, under the present circumstances, the dollar may decline farther and faster than it did in 1979. A crisis might even shatter an already shaky global financial system. Further, financial markets may simply be overwhelmed by the lightening speed of modern computer-driven financial transactions in a time of panic. Such developments would be more dangerous given that there is a huge divide between the United States on the one hand and France, Germany, and Russia on the other in regard to the Iraq war.

The tools available to the United States to handle such a crisis are also weaker now. A sharp increase in interest rates to increase the demand for dollars is likely to precipitate economic downturn, perhaps far more severe than that of the early 1980s. During the 1979-82 crisis, large tax reductions and budget deficits followed the rise in interest rates, providing stimuli to the U.S. economy. This time the tax breaks have already been handed out, the federal deficit is already large, and the total debt burden is also high. Increasing interest rates to stem a fall in the value of the dollar and the concomitant inflation would, in the absence of higher taxes, cause drastically higher federal interest payments, declining tax revenues, and rapidly escalating deficits. A declining dollar may not even produce an improved trade balance for the United States. Figure 2 shows that the decline in the dollar relative to the yen in the past three decades has been accompanied by rising U.S. trade deficits with Japan partly because Japan's resource imports have become relatively cheaper for it due to the same reason.

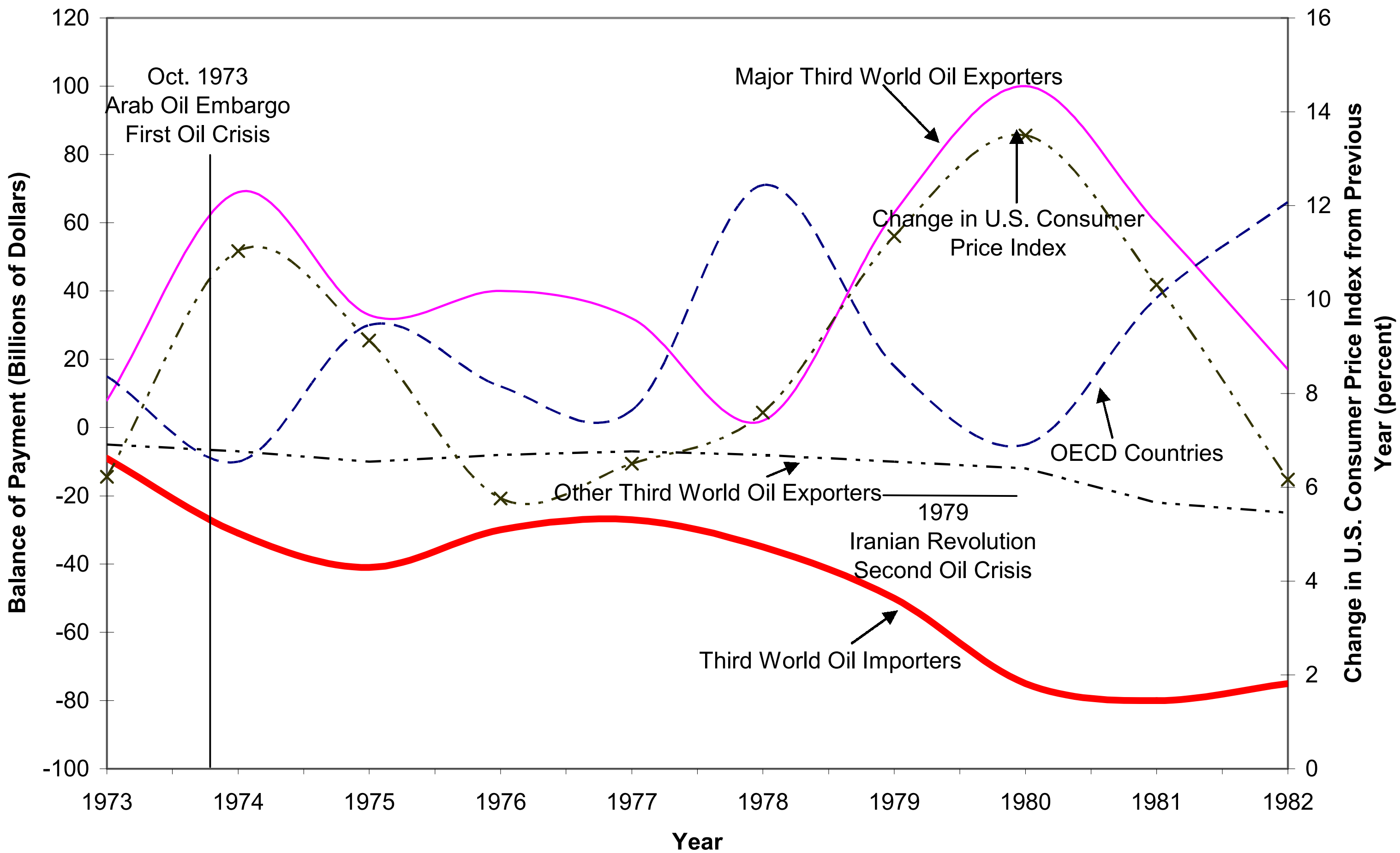
Further, the current crisis is also exposing military vulnerabilities of the United States that have been obscured by the talk of a single superpower that won the Cold War. While the Soviet Union lost the Cold War, the military position of the United States in the aftermath does not correspond to a classical definition of victory. Russia still has a vast arsenal of nuclear weapons and the United States cannot disarm Russia unless it agrees to get rid of its own nuclear weapons as well. The U.S. has been reluctant to do that because it wants to keep its weapons. It has adopted policies increasing the potential circumstances in which nuclear weapons could be used. This is aggravating proliferation problems. For instance the naming of Iran as a part of an "axis of evil" has likely strengthened the pro-nuclear-weapons lobby in Iran. A similar strengthening of the pro-nuclear lobby in India occurred when the United States sent a nuclear-armed aircraft carrier to the Bay of Bengal curing the Pakistan-India-Bangladesh war in 1971.

The threats of nuclear proliferation and the problems of terrorism have made the global military and political situation very complex. The problem is compounded by the fact that the epicenter of the political-military crisis is also in the heart of the world's largest oil resources. Currency turbulence and a *de facto* competition between the euro and the dollar compounded by war and oil supply uncertainties could produce military and financial chaos.

The present system that has allowed the U.S. to simply print money and accumulate IOUs to the world is not only inequitable, it is also unstable. A U.S. war on Iraq in the face of overwhelming global opposition is far more risky and dangerous enterprise than is generally realized. The potential for monetary competition between the dollar and the euro would add to the already combustible mix of problems.

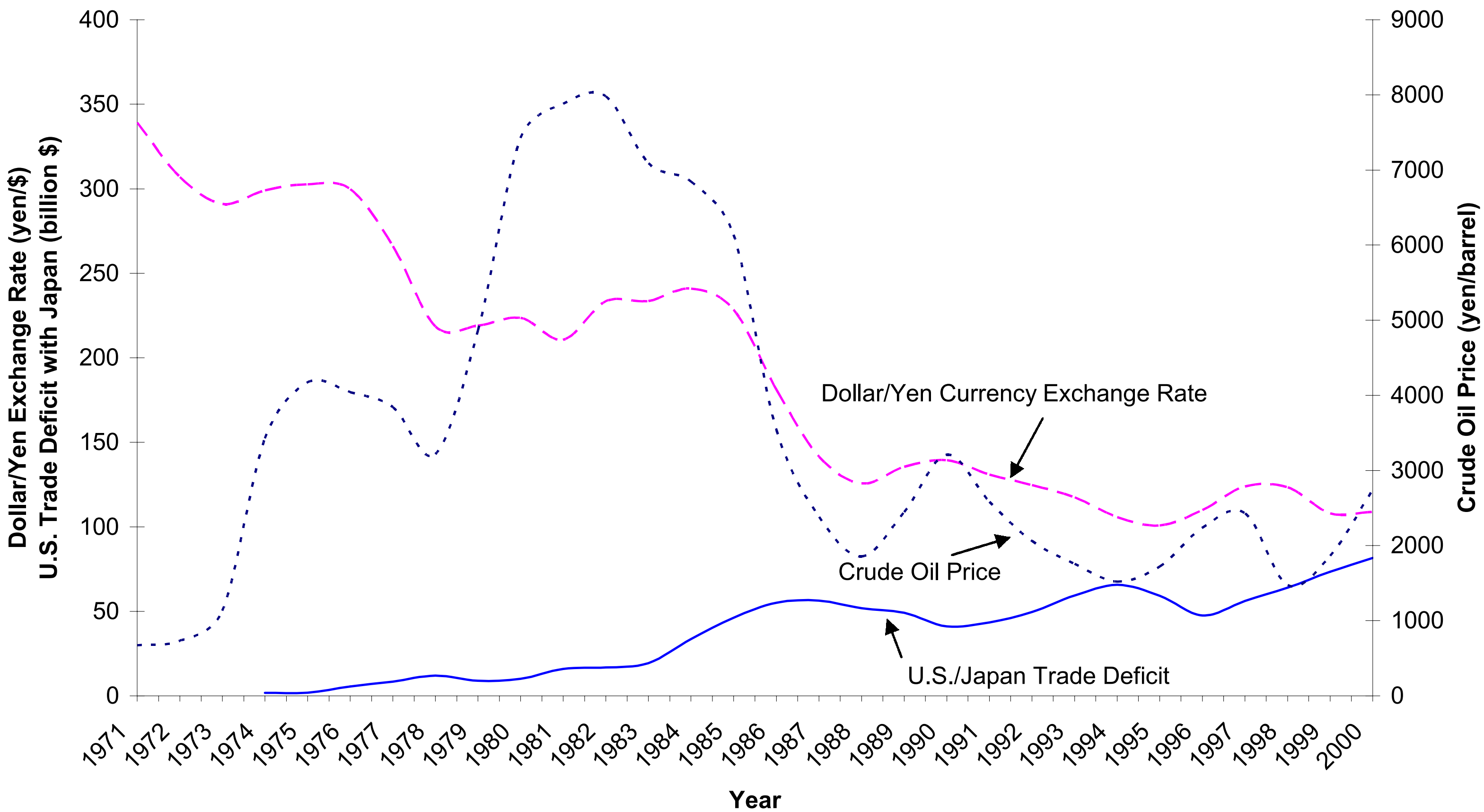
The late 1990s saw an emerging global consensus that a change in global financial and economic arrangements was necessary. These debates, which began in earnest during the 1997-98 Asian, Russian, and Mexican financial crises, have seemingly been on a separate track from the issues of war and peace and oil. They have been seen as concerning the Third World: trade, capital flows, and International Monetary Fund conditionalities ("prescriptions") for loans. But monetary questions are now also linked to global financial stability in ways that could profoundly affect the United States and the entire West and to war, peace, and disarmament. In other words, the developing countries' need for reform is now complemented by the same need on the part of the United States, Europe, and Japan. A new Bretton Woods conference to create a more flexible and equitable global financial system is an urgent need, as is a United Nations decision that ridding the whole world of weapons of mass destruction should be accomplished by a permanent and robust regime of international inspections.

Figure 1: Balance of Payment and Debt Crises--1973-1982



Source: Adapted from *Oil Prices and the Crises of Debt and Unemployment*, Fig. 2, Makhijani, 1983 and the *Statistical Abstract of the United States,* 1999, Table 1435.

Figure 2: Dollar/Yen Exchange Rate, U.S./Japan Trade Balance, and Crude Oil Prices--1971 to 2000



Source: Data collected from the St. Louis Federal Reserve Bank, and the U.S. Census Bureau