

Is there an alternative to the dollar for setting oil prices?

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As price volatility adversely affects both oil producers and consumers, there have been continued talks about replacing the dollar with other currencies to help reduce oil price volatility. In fact, an English newspaper recently reported that the Persian Gulf countries are planning to reduce the impact from the US dollar volatility on oil prices by adopting a basket of currencies including the Japanese yen, Chinese yuan, euro, gold and a new unified currency planned for nations in the Gulf Cooperation Council (GCC).

At face value, the US dollar is just a unit of account for price quotation. A change in the dollar value has, therefore, no immediately significant effect on the real value of oil. That said, the correlation between US dollar and oil price is normally negative for various reasons. For example, a weak dollar could raise oil demand from net-oil-importing (de facto dollar) countries by increasing their purchasing power. Some countries indirectly subsidize imported oil priced through currency appreciation. Investors also trade the US dollar against other inflation-hedged assets like oil and gold. The correlation between daily returns between the dollar and oil has generally been negative, with the recent rising in oil price partly contributed by weakening dollar.

If not the US dollar, which currency would be a better unit of quotation for world oil prices? Potential currency candidates have to be highly reliable and credible for oil market stakeholders, with relatively low volatility most of the time. According to these criteria, no currency presently has obvious advantages over the US dollar in the foreseeable future. A basket of currencies could potentially be a good alternative since it can diversify risks associated with an individual currency. However, it would also be difficult to achieve broad agreement on the choice and weight of each currency within the basket.

Pricing in a basket of currencies may make the oil price appear to move like a stock index. Consequently, it may be hard for participants to trade an unfamiliar and complicated index instead of an easily understood dollar-based commodity. In fact, oil buyers/sellers are likely to

convert this index into their preferred currency for transaction settlement in any case. Since the cost-effective international currency is still the dollar, major oil producers and consumers are trapped in the attempt to reduce the impact of US dollar movement on oil price volatility.

Reflecting uncertain global trade and financial movements, many market watchers anticipate that the dollar would remain volatile for several years to come with a relatively greater risk for depreciation, hence the continued volatility of world oil prices.

Volatile price movements diminish growth potential and world economic welfare and it is not good news for consumers and producers. Perhaps it is time for dominant countries in the oil industry to sort this problem out in a more efficient way than just changing the unit price of oil.

(The views expressed are the author's own.)

Published in The Nation on Tuesday, November 10, 2009