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## The Iranian Oil Bourse, A Threat to Dollar Supremacy?

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# The Iranian Oil Bourse

## *A Threat to Dollar Supremacy?*

Robert Looney

*Contrary to the writings of many political analysts, there are many fronts on which to battle the United States. Iran has considered opening another front by leading an assault on the U.S. dollar. Will it succeed? Our writer thinks it will not, partly because, as of now, the dollar's sources of strength are considerable. But he realizes that the dollar could come under more serious pressure in coming years.*

*Contemporary warfare has traditionally involved underlying conflicts regarding economics and resources. Today these intertwined conflicts also involve international currencies and thus are increasingly complex.<sup>1</sup>*

*Iran's nuclear projects, alleged weapons of mass destruction (WMDs), or its supposed support of "terrorist <<no end of quote>> organizations, as the Bush administration claims, do not pose a threat to Washington. What does pose a threat is Iran's attempt to reshape the global economical system by converting it from a petrodollar system to a petro-euro system.<sup>2</sup>*

*It is enough to make the Great Satan-loathing visionaries behind the Iranian regime salivate.<sup>3</sup>*

*If, as is widely believed, the tales of the 1001 Arabian Nights came out of Persia, then Iran, Persia's modern successor, has given the world yet another great fantasy: the Iranian oil bourse.<sup>4</sup>*

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<<need more au bio>> Professor, Naval Postgraduate School

SINCE THE UNITED STATES EMERGED AS THE DOMINANT GLOBAL SUPERPOWER AT the end of World War II, U.S. hegemony has rested on three unassailable but somewhat interconnected pillars: (1) overwhelming U.S. military superiority over all its rivals, (2) the superiority of American production methods, and (3) the relative strength of the U.S. dollar as the global reserve currency. However, outside the mostly arcane academic discussions the role of the dollar has received surprisingly little attention, given that the dollar's continued international role is the most vulnerable pillar, and its ability to support the other two pillars is increasingly questioned. In this light, Iran's decision to open a euro-denominated Iranian oil bourse (IOB) is seen by many as an aggressive attack on the weakest link in America's global security system:

Iran does not pose a threat to the United States because of its nuclear projects, its WMD, or its support of "terrorist organizations," as the American administration is claiming, but in its attempt to reshape the global economic system by converting it from a petrodollar to a petroeuro system. <<This quote is almost the same language as the second paragraph, which must be a paraphrase, and each has a different citation.>> Such conversion is looked upon as a flagrant declaration of economic war against the US that would flatten the revenues of the American corporations and eventually might cause an economic collapse.<sup>5</sup>

Proponents of the IOB contend that the bourse will enable petrodollar currency hedging, thus fundamentally altering the dynamics of oil and gas trades around the world. If the IOB succeeds, the U.S. will no longer be able to effortlessly expand credit using U.S. Treasury bills, and the dollar's demand/liquidity value will fall.

The tacit assumption underlying Iran's pending attack on the dollar is that the dollar's role in oil markets absolves the United States from the harsh economic laws governing activity in other countries—that the role of the dollar is ultimately responsible for much of the economic, military, and political strength of the United States.

In fact, many Web sites (for example, [www.pressurepoint.org/pp\\_its\\_the\\_oil.html](http://www.pressurepoint.org/pp_its_the_oil.html)) are currently peddling the theory that the United States invaded Iraq because in 2000 Saddam Hussein had switched

from dollars to the euro as the medium of exchange for purchasing Iraqi oil—that the invasion was largely undertaken to discourage the Organization of Petroleum Exporting Countries (OPEC) and other oil-exporting countries from following suit. While many of these sites vary in detail, the logic of their arguments is broadly similar:<sup>6</sup>

1. The United States has a great economic interest in maintaining the existing dollar based system—petrodollars eventually end up in the hands of foreign companies and governments, which in turn look for a safe place to invest them.
2. There is a natural inclination to shift the dollars back to the United States, thereby avoiding any currency risk.
3. Back in the United States, the dollars flow into assets such as U.S. bonds, keeping interest rates low, or into equities, thus creating stock market appreciation.
4. In both cases, the United States benefits from greater availability of investment capital, which is subsequently used to fuel growth in a noninflationary environment.
5. The great demand for the dollar (aided by the fact that oil is paid for in dollars) helps maintain its strength in international currency markets despite the rapid outflow from the United States driven by massive current account deficits.
6. Most important, the strong dollar lessens the real costs borne by the United States in Iraq. Specifically, because countries have to hold large amounts of dollars as reserves to pay for their oil, the United States can in effect exchange the paper it prints for real goods and services many of which ultimately wind up in places like Iraq or Afghanistan. The same arguments were made by the French during the time of the Vietnam war.

In sum, proponents of the IOB contend that the dollar-priced oil system creates a virtuous cycle for the United States, making the country's massive trade deficit tolerable and its foreign military operations financially bearable. In effect, the existing dollar/oil system allows the U.S. government to run up a massive deficit without rising **<<OK? Not raising?>>** interest rates as foreign dollars are used to purchase

U.S. government debt. The economy thrives because the U.S. private sector is not crowded out of the financial markets through normally rising interest rates. The net result is to allow strong levels of consumption and investment despite the country's extraordinary low rates of saving. The net result: the United States can pursue overseas military operations without being encumbered by the resource constraints facing all other countries—the United States can have both guns and butter. It follows that breaking the dollar/oil link would drastically reduce the role of the U.S. dollar as an international reserve currency, and thus also reduce the country's military/economic power.

The mechanisms of the dollar's demise as a result of severing its link with oil are often assumed by oil bourse proponents to be relatively straightforward: Because a certain portion of existing dollar reserves will not be needed to pay for oil, other currencies like the euro will be used for this purpose, thus becoming more attractive. The dollar will begin to fall in value, causing many holders to switch to other currencies in anticipation of further declines. With rising import prices, caused by the dollar devaluation, and increased inflation in the United States, the Federal Reserve will tighten the money supply, slowing down economic activity and investment. With the decline in economic growth, other holders of the currency will doubt the country's medium-term prospects and its ability to service its massive external debts. Investor panic will precipitate a collapse of the dollar and, ultimately, the U.S. economy.

While one may take issue with the above scenario or some of its main assumptions, the fact remains that there is rising speculation in the mainstream financial press that the dollar's reign is in slow decline. This speculation coincides with increases in the U.S. balance-of-payments deficits, currently at an all-time high of nearly 7 percent of the gross domestic product (GDP). The presumption is that the United States is living way beyond its means and that a day of reckoning is nearing. In fact, during the past thirty years, the dollar has had four bouts of market depreciation. At one point, during the most recent one, which began in 2002, it fell by 28 percent against the euro and by 14 percent against a broad basket of currencies.<sup>7</sup> Clearly there is

concern that the dollar may be increasingly vulnerable to shifts into other currencies, and, with that, its role as a reserve currency in jeopardy. In this case the IOB would simply accelerate the abandonment of the dollar.

Summing up, Iran's plan of attack is not without economic logic. Proponents of the IOB recognize that the heavy use of the dollar in international trade sustains its foreign exchange value by inducing people to hold greater dollar balances than they otherwise would. The dollar's ensuing strength encourages its use in other transactions, which requires still greater dollar holdings in a dollar-augmenting cycle enabling the United States to have more of both guns and butter at little or no extra cost.

Is there a good chance the proposed Iranian euro-denominated oil bourse might be the catalyst that sets off a mass flight from the dollar? If so, what additional follow-on factors might contribute to the dollar's demise? Or, conversely, are there good reasons to discount the IOB's ability to influence international dollar holdings and thus its value in the major foreign exchange markets? If so, what factors might counter the IOB-based scenario outlined above? Can certain U.S. actions enhance these forces?

### **Creation of an Iranian Euro-Denominated Oil Bourse**

The proposal to set up the Iranian oil bourse first appeared in Iran's Third Development Plan (2000–2005). Initially, the intention was to make the IOB operational by March 20, 2006, with the bourse located not in Tehran but on distant Kish Island. Officially, the purpose of the IOB was to make Iran the main hub for oil contracts in the Gulf region.

Clearly, Iran has some inherent advantages over other potential sites: The country is the world's fourth-largest producer of oil and is in close proximity to Europe and two of the most rapidly growing markets, India and China.<sup>8</sup> Furthermore, the IOB has the potential to provide Iran with concrete economic benefits. Invoicing oil in euros would be logical for Iran, as trade with the euro zone countries ac-

counts for 45 percent of its total trade. More than a third of Iran's oil exports are destined for Europe, while oil exports to the United States are nonexistent.<sup>9</sup>

Having overcome the major obstacle (lack of a benchmark oil denominated in euros) to the adoption of euro-pricing in the oil markets, is the IOB likely to result in a significant shift out of dollars, thus perhaps precipitating that currency's fall in value and eventually its use as an international reserve currency? Here at least three considerations appear critical: (1) What domestic factors are likely to constrain development of the IOB, and how great an effect will they have on establishing the bourse in Iran? (2) Assuming the IOB is established and operational, is the likely shift into euros for oil trading purposes account for a significant share of international reserves? (3) Are there any offsetting factors likely to be at work to cause countries to hold a large share of their reserves in dollars, irrespective of progress made by the IOB?

### **Domestic Constraints on IOB Development**

First, there is the question of how much crude an Iranian oil bourse could handle. Iran is the world's fourth-largest producer of crude, pumping only about 5 percent of the world total, and is unlikely to add much to that. The Iranian fields are mature, and over the next decade, production will probably begin to decline, especially if the U.S. sanctions continue. Other countries that are likely to trade on the IOB probably would include Venezuela, the world's tenth-largest producer—no other countries have shown interest in participating in the new oil bourse.

Clearly, many factors specific to Iran continue to limit the attractiveness of the country as a location for an international oil market. These relate mainly to the country's relative underdevelopment across a whole spectrum of economic, governance, and social dimensions, each of which casts some doubt on the country's ability to develop a competitive alternative to the existing oil markets.

The extent of Iran's relative underdevelopment and the daunting



magnitude of its competitive disadvantage are probably best revealed in a number of key indices that look at: globalization, governance, economic freedom, access to capital, and indicators of failed states.

### ***Limited Integration into the International System***

Globalization is a multifaceted phenomenon with no one factor fully capturing its impact on national economies. The *Foreign Policy* globalization index<sup>10</sup> looks at several indicators spanning trade, finance, political engagement, information technology, and personal contact to determine the rankings of sixty-two countries that account for 96 percent of the world's gross domestic product and 85 percent of the world's population. The index measures twelve variables, which are divided into four "brackets": economic integration, technological connectivity, personal contact, and political engagement.

All indices of this type are inherently arbitrary. Still, the fact that Iran ranks last in the 2005 index (out of 62 countries) suggests a major policy failure. When viewed by subcategory, an interesting picture emerges: Iran ranks 51st in the economic area, 62d in the personal dimension, 48th technologically, and 61st in political engagement. Iran's external progress appears greater in the economic arena than political ones, with the Islamic republic ranking 47th in trade openness and 48th in foreign direct investment. Still, Iran is a relatively isolated country that has forgone many of the distinct benefits derived from integration into the global economy, a conclusion reinforced by the country's technological connectivity rankings, where it is 42d, 57th, and 61st, respectively, with regard to Internet users, Internet hosts, and secure servers.

### ***Deficient Governance Structures***

While the ranking of countries' progress toward improved governance is inherently subjective, a recent World Bank study<sup>11</sup> provides a set of rankings based on a set of estimates of six dimensions of governance covering 199 countries and territories for 1996, 1998, 2000, and 2002.



The dimensions measured include: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption.

On the whole, Iran lags considerably behind other countries in most areas of governance. In fact, the country is not above the mean in any category. While, relative to the base year of 1996, some progress has been made in regulatory quality, rule of law, and corruption, there has been a decline in the areas of voice and accountability, political stability, and government effectiveness. The extremely low levels of regulatory quality and the rule of law represent major obstacles to the development of an international oil bourse.

### ***Little Progress Toward Economic Freedom***

The protection of an individual's rightfully acquired property and his ability to exchange that property with others is the cornerstone of economic freedom. According to this definition, the Index of Economic Freedom compiled by the Heritage Foundation/*Wall Street Journal*<sup>12</sup> classifies Iran as repressed, with Iran scoring 148th out of 161 countries in 2005. With zero indicating the highest level of economic freedom and 5 indicating the lowest, Iran receives the lowest score in four key areas:

*Government Intervention in the Economy.* The country's low ranking was based on a high concentration of inefficient state-owned enterprises, combined with politically powerful individuals and institutions, such as the Islamic charities, whose tight grip on the non-oil economy through preferential access to domestic credit, foreign exchange, licenses, and public contracts crowds out the private sector.

*Regulation.* Despite recent attempts at reform, rules controlling business practices are poorly enacted and implemented in Iran, effectively discouraging the establishment of new businesses. Contract negotiations are often lengthy, prolonged by exhaustive details demanded by state agencies and the slowly functioning bureaucracy, and contracts require approval from an extensive number of higher officials before they can be concluded.

*Banking and Finance.* Because Islamic law restricts the ability of banks to charge interest, this sector is dominated by state-owned banks. The bulk of commercial banks' loan portfolios are taken up with low-return loans to state agencies and parastatals.

*Property Rights.* Property rights are not protected in Iran. Recourse to the courts is costly, unwieldy, and often counterproductive, and rarely leads to the swift resolution of outstanding disputes. Few foreign firms have had satisfactory experiences when seeking to bring a contract dispute before a court.

### **Capital Market Development**

There is a reason the world's two major oil markets are located in the world's major financial centers, New York and London. Supporting financial structures greatly assist oil traders' ability to quickly raise and place the vast sums of money flowing through the markets each day. While the *Heritage/Wall Street Journal* index suggests that Iran has made some progress in capital market development, the greater level of detail provided by the Milken Institute Capital Access Index (CAI)<sup>13</sup> allows for a more comprehensive assessment.

The CAI measures not only the breadth, depth, and vitality of capital markets, but also the ability to gain access without discrimination. The index is made up of seven factors affecting a country's financial markets: macroeconomic environment, institutional environment, financial and banking institutions, equity market development, bond market development, alternative sources of capital, and international access. By this index, Iran again rates low. Out of a total sample of 121 countries, Iran ranked 93d in 2003, with its rank increasing to 69th in 2004 before falling back to 79th (behind Mongolia and Uganda) in 2005.

Insight into the causes of Iran's low capital access ranking can be gained from examining its scores on some of the index's individual factors. For example, ranking below the Central African Republic and Honduras at 93d in 2005, Iran scored extremely low in the extent to which its macroeconomic environment is favorable to the running

and financing of a business. It came in at 87th, again just behind the Central African Republic, in the level of involvement of deposit-taking financial and banking institutions in business financing. Finally, the Islamic republic is nearly devoid of alternative sources of capital—venture capital, private placement and credit cards—ranking 104th behind Burundi and Guinea. Needless to say, the country's international access to capital was also extremely low, ranking 98th behind Angola and Armenia.

### ***Aspects of a Failed State***

Iran is increasingly appearing on lists of “failed states.” By definition, a failed state suggests a massive breakdown of policies, many of which were presumably avoidable. Obviously, a government that has lost control of its territory or of the monopoly on the legitimate use of force qualifies as a failed state. However, there can be more subtle attributes of failure, such as lacking the authority to make collective decisions, the capacity to deliver public services or collect taxes, or the power to curb large-scale civil disobedience.

The Fund for Peace and *Foreign Policy* created a global ranking of weak and failed states.<sup>14</sup> Using twelve social, economic, political, and military indicators, they ranked sixty states in order of their vulnerability to violent internal conflict, with 1 being the worst and 60 the best. Iran fared considerably better than in the case of globalization, ranking 57th.

Scores on the index's individual components range from 1 to 10, with 10 being the worst. Iran's individual scores were as follows: (1) Demographic Pressures [5.0]; (2) Refugees and Displaced Persons [8.0]; (3) Group Grievance [7.3]; (4) Human Flight [6.0]; (5) Uneven Development [9.0]; (6) Economic Decline [6.7]; (7) Delegitimization of State [8.1]; (8) Public Services [7.0]; (9) Human Rights [7.9]; (10) Security Apparatus [6.0]; (11) Factionalized Elites [8.3]; and (12) External Intervention [6.0].

Among the twelve indicators, *Foreign Policy* and Fund for Peace argue that two are critical indicators of a failing state. They claim

that uneven development, which indicates inequality within states, and not poverty, is extremely instrumental in increasing instability, as is the criminalization or delegitimization of the state that occurs when state institutions are regarded as corrupt, illegal, or ineffective. Notably, Iran scores very high in both these categories.

Clearly there are many similar and related indices measuring progress along different dimensions. Unfortunately for Iran, they all paint pretty much the same picture of a country that has been left behind by the worldwide economic and political reform movements that began in the 1980s, with the so-called Washington Consensus stressing efficiency, economic stability, and integration into the world economy. The implications for Iran's proposed oil bourse are clear:<sup>15</sup>

1. Tehran's exchange is simply not attractive compared with the exchanges in London and New York, where dealers and traders are prospering amid their well-developed networks. On distant Kish Island, they would (a) lack trained locals to work in their operations, (b) have to deal with a notoriously corrupt bureaucracy, (c) lose contact with an efficiently regulated transparent financial system, (d) lack the necessary technological infrastructure, and (e) sever most links to the globe's electronic commercial structures on which trading relies.
2. Because Iran is not even a member of the World Trade Organization, dealers who move to Kish Island would also miss the kind of legal structures on which they rely to facilitate trade and secure the contracts that support it. Furthermore, a firm's move to Kish would subject any staff assigned there to Sharia law. Western oil company employees tolerate that burden because they must go where the oil is. The same is not true of futures trades. <<traders?>>
3. Iran's proposed bourse would also face serious diplomatic and religious problems. To work the exchange would require a free flow of funds and oil, but Iran's membership in OPEC subjects it to strict production and sales quotas.<sup>16</sup> It is not at all clear how Tehran plans to reconcile one requirement with the other. Most

fundamental of all, at least for many Iranians is the likely violation of Islamic law. The Koran forbids either paying or receiving interest; futures contracts always carry an implicit interest for the time value of money. On this basis, the bourse could pose more of a problem for relations between Iran's government and its people than for the dollar.

Against this long list of impediments, it is difficult to see how such an oil exchange could even get started—modern, cosmopolitan Dubai with vastly superior governance and progress at economic reform is struggling to find a significant niche for its oil exchange. Furthermore, the Iranian government is unconvincing in its argument that proximity to the Middle East oil fields can overcome other reservations, especially in today's electronic age. Neither can Iran use its oil production, as it hinted, to force traders and dealers to its exchange. As long as Iran sells its oil onto world markets, it has no control over where it gets traded.

In sum, Iran has a number of gaping governance and institutional deficiencies that will severely limit the growth and prosperity of a new oil bourse. Perhaps over time, with the correct mix of economic reforms and institutional development, the country could attract a reasonable number of traders and take some business away from the two incumbent dollar-based exchanges. If this occurs, are there further obstacles to dethroning the dollar? At issue are the workings of the international system and Iran's ability to decrease the attractiveness of the dollar within that system.

## **Workings of the International System**

In terms of external developments, the expected value of the dollar would appear to be the key factor affecting the currency that other producers would want to denominate their oil sales. From the perspective of the oil producers, some simple rules apply:<sup>17</sup>

1. At one level, the currency in which you price your products is largely a matter of bookkeeping. The Saudis can price their oil

in dollars, or the South Africans in their gold, or the French in the new Airbus SAS aircraft, without its making much difference to their actual income. As soon as the dollars come in, they can sell them for whatever currency they want. If you are uncertain about the future price that your product is likely to command, then you can buy and sell currencies in the futures markets. Just because you price a product in that currency, you are not compelled to hold that currency.

2. In the medium term, it does matter. The producers of any product are looking for high stable prices. If your product is priced in a permanently weak currency, then you have to keep raising the price. That is far from satisfactory. At some point the temptation to switch to a stronger currency will become irresistible.
3. Much depends on the future path of the dollar. [As of February 2005] it has been weak for about three years now. **<<update? this is two years later. Also, some of references are 2006, so some of article at least was written updated to then>>** So far, producers have responded with higher prices. Two more years of dollar weaknesses **<<have we had those?>>** and they may well decide to take more radical action.

The key question is whether the dollar will be able to maintain sufficient value to discourage oil producers from switching to another pricing currency. If not, how far would the dollar have to fall before producers would want to switch to another currency such as the euro? A related issue is the extent to which crude-oil importers will want to pay in euros rather than dollars. Although, as noted earlier, the use of the dollar as the international system's fiat currency has been declining for about thirty years, some 70 percent of international currency reserves that finance international trade are still in U.S. dollars. Japan and China alone have built up nearly \$2 trillion in U.S. Treasury bonds and other low-interest-earning dollar assets. Will these and other major countries be content to continue holding a large percentage of dollar reserves irrespective of developments in the Iranian oil bourse?

As implied above, the answer to these questions will most likely

depend on the view one has concerning the causes and sustainability of the United States' balance-of-payments deficit on current account. Surprisingly, despite the importance of the international financial system and the volumes written on it, there is still a lack of general agreement amongst economists on the underlying determinants currently driving the U.S. current-account deficits.

In fact, currently there are three different views of the factors mainly responsible for the massive U.S. current-account deficits: (1) the trade view, in which trade flows are the primary factors and the offsetting capital inflows are secondary; (b) the gross domestic product view, in which the current-account deficit is perceived as a shortfall between domestic investment and domestic savings; and (c) the capital flows view, in which the trade and current account deficits are a result of the capital account surplus.

If the U.S. current account is viewed in the first sense—as a function of U.S. overspending/lack of competitiveness, then it is usually seen as unsustainable and thus crisis prone. A likely outcome would be a gradual decline in the value of the dollar or, even worse, a possible collapse of the dollar following an adverse shock to the system. In either case, dollar-dominated foreign exchange reserves are risky. A shift to euros would be more likely, and with it an increase in euro-denominated oil sales.

Nearly all the scenarios linking the Iranian oil bourse to the demise of the dollar either implicitly or explicitly rely on this interpretation of the U.S. balance of payments. While this view seems to make the most intuitive sense, especially to noneconomists, it is biased toward the most pessimistic outcomes for the dollar.

The second view stressing savings and investment imbalances often sees long-run demographic patterns as supporting the dollar.<sup>18</sup> Proponents of this position contend that (1) the sustainability of the U.S. current-account deficit is a function of the rest of the world's savings and investment pattern, and (2) the rest of the world's savings behavior is significantly affected by their demographic trends. Asia, particularly China, is currently experiencing large percentages of its populations in the high-savings age groups. For many of these countries, savings



outstrip the number of profitable investment opportunities and, as a result, are placed in the broad and deep U.S. capital markets. In essence, this interpretation attributes the high U.S. current-account deficits to excessive external savings, rather than overspending in the United States. In this way, the resilience of the dollar in the face of a massive current-account deficit is due in large part to developments outside the United States.

On the other hand, if the U.S. current account is viewed in the third sense—as largely reflecting relative rates of return across countries with the United States seen as a more attractive investment destination—then the dollar’s ability to maintain its value is even less of a concern. This was essentially the view of Nobel laureate Milton Friedman, who contended that the U.S. current account was in deficit simply because foreigners wanted to invest in the United States.

This view was predicated on the idea that the capital account (voluntary inflows of capital) of the balance of payments determines the current account (largely goods and services). If this is the case, the financing and sustainability of the U.S. current-account deficits should not raise concerns about the future value of the dollar. The value of the dollar would not have to decline to assist in reducing the size of the deficit, nor would it fall in value stemming from investor concern over the ability of the United States to service its external debt. The share of dollar-denominated reserves might even continue to increase. There would be no special motivation to hold euros for the purpose of importing oil.

There is no reason why the second and third views cannot coexist simultaneously. Currently, many feel we are in a period of excess world savings (mainly East Asia and the Gulf oil states) and relatively high returns on U.S. assets. This explanation would easily account for the dollar’s strengthening since early 2005, despite growing deficits in the current account.

In sum, the second and third views are much more amenable to sustainable scenarios, with the likelihood of a dollar crisis or devaluation much less likely. These views stress that the United States is in an exceptionally advantageous situation because it does not need to

borrow in a conventional sense. Part of the financing of the U.S. current-account deficit comes voluntarily because of the attractiveness of the United States as an investment destination, providing generally higher rates of return than obtainable elsewhere—because of the size, scope, openness, and liquidity of the U.S. capital markets, and because of the dollar's role as the world's prime investment, transaction, and reserve currency.

Interest rates are determined by the conditions in the U.S. money and capital market rather than dictated by the lenders. And, unlike most other countries, the United States has the ability to finance its external deficits in its own currency. There is no doubt that this relative easiness in financing is an important factor in sustaining the U.S. trade and current-account deficits.

Which of the three interpretations of the U.S. balance of payments is more likely to be correct? Clearly, no definitive answer is possible—there is no doubt some truth in all three interpretations. However, one can gain a sense as to their relative explanatory power by delving a bit deeper into how the workings of the current world system may affect the attractiveness of the dollar as a reserve currency; in particular, the willingness of central banks to link domestic currencies, either loosely or tightly, to the dollar—the, <<some missing or wrong here>> existence, pervasiveness, and longevity of the so-called Bretton Woods II system.<sup>19</sup>

Bretton Woods II is not an official system. It is simply a construct many economists use to describe what they consider to be the de facto manner in which countries are currently managing their exchange rates and balance-of-payments positions. Under the original post-World War II Bretton Woods system, the dollar was officially linked to gold, with other countries committed to maintaining par values of their currencies with the dollar. That system was inherently unstable and collapsed in the early 1970s under the stresses brought on by irresolvable current-account imbalances between the deficit countries (mainly the United States) and surplus countries (mainly Germany and Japan).

Under the current informal system, with no official exchange-rate

commitments, proponents of the Bretton Woods II interpretation view the large U.S. balance-of-payments deficits (current account) as largely reflecting a conscious fixed-exchange-rate policy at undervalued rates undertaken by several of the major East Asian central banks. The purpose of this undervaluation on the part of the Asian countries is twofold: (1) build up reserves to guarantee that a repeat of the 1997 Asian financial crisis will not occur, and (2) enable the countries to pursue an aggressive export-led growth-development strategy by being super-competitive in the large and growing U.S. domestic market. To prevent their currencies from appreciating, these countries, particularly China, are buying up dollars and dollar-denominated assets, thus contributing to the U.S. current-account deficits.<sup>20</sup>

Recent patterns of international financial flows are consistent with this interpretation:<sup>21</sup>

1. U.S. financial markets have stayed strong even as the financing of the U.S. deficit shifts from private investors to foreign central banks (from 2000 to 2003, the official institutional share of investment inflows rose from 4 percent to 30 percent).
2. A large percentage of the \$1.3 trillion in Asian governments' foreign exchange reserves is in U.S. assets; central banks now claim about 12 percent of total foreign-owned assets in the United States, including more than \$1 trillion in Treasury and agency securities.
3. Official inflows from Asia will likely continue for the foreseeable future, keeping U.S. interest rates from rising too fast and choking off investment.

Bretton Woods I collapsed under the weight of imbalances considerably smaller (as a share of GDP) than the ones today. How long can the Bretton Woods II system continue? In a series of recent papers,<sup>22</sup> Michael Dooley, David Folkerts-Landau, and Peter Garber maintain that Asian governments—pursuing a “mercantilist” development strategy of undervalued exchange rates to support export-led growth—must continue to finance U.S. imports of their manufactured goods, since the United States is their largest market and a major source of inward

direct investment. After China completes the current phase of its development (perhaps in a decade or so) and goes to a flexible exchange rate, India will then provide the main backing for the dollar with a rupee/dollar link—the system can continue for at least several decades.

In short, the Bretton Woods II system implies that only a fundamental transformation in Asia's growth strategy could undermine this mutually advantageous interdependence—an unlikely prospect, at least until China absorbs the 300 million low-skill workers from the interior provinces expected to move into its industrial and service sectors over the next generation.<sup>23</sup>

In a similar vein, Ronald McKinnon <<and Gunther Schnabl?>> of Stanford argue that Asian governments will continue to prevent their currencies from depreciating too much in order to maintain competitiveness, avoid imposing capital losses on domestic holders of dollar assets, and reduce the risk of an economic slowdown that could lead to a deflationary spiral.<sup>24</sup> According to both theories, there should be no breakdown of the current dollar-based regime.<sup>25</sup>

Another variant of this model has been developed by Stephen Jen of Morgan Stanley.<sup>26</sup> Jen believes that the dollar has been particularly stable because the world system is forming a large de facto dollar zone—an area where countries settle their international transactions and payments using the dollar. Currently the de facto dollar zone includes China, Japan, and many of the East Asian countries, as well as the oil-exporting members of the Gulf Cooperation Council (GCC)—in essence the two main blocs of balance-of-payments surplus countries.

The dollar-zone interpretation of today's international financial system is much less restrictive than Bretton Woods II. While Bretton Woods II requires exchange rate fixity and undervaluation of the Asian currencies pegged to the dollar, all that is needed for a big bloc of countries to rely on the dollar for international transactions is that their own currencies are not fully convertible. Currency fixity or undervaluation is not necessary for a country to qualify as a member of the de facto dollar zone. The important point is that even if countries

like China abandoned the Bretton Woods II system, they would most likely stay in the de facto dollar zone until they could carry out the reforms necessary to support their own convertible currencies—again a process that may take years. It follows logically that the bulk of international trade will continue to be settled in U.S. dollars, especially trade between and with the Asian countries.

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In the face of such strong forces acting to maintain the strength of the U.S. dollar despite growing current account deficits, is there any way that the Iranian bourse could set off a decline in the value of the dollar, or reinforce a decline caused by other factors that might gain momentum and cause a shift away from dollars toward euros and eventually more oil transactions in euro-denominated prices? It is hard to conceive that the Iranian bourse, given its likely slow start-up and limited volume, would be capable by itself of affecting the value of the dollar. As for its ability to reinforce a growing retreat from the dollar, the number of credible scenarios relying mainly on economic factors appears limited—the most likely being the oil countries, especially if those in the Gulf in search of better yields begin spending their oil receipts on euro assets.

The sharp rise in oil prices over the past three years (from around \$30 a barrel in 2003 to over \$70 throughout most of 2006) has significantly altered the ownership composition of the excess savings outside the United States.<sup>27</sup> This will alter the dynamics of the currency markets in important ways:<sup>28</sup>

1. In 2005, the United States current-account deficit reached US\$760 billion.
2. By 2006, according to the International Monetary Fund (IMF), OPEC's current account surplus could reach US\$337 billion, compared to Asia's current account surplus of US\$362 billion.

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To date there is little direct, tangible evidence pointing at a mass exodus of investment from the United States or U.S. denominated

assets. The favored outlet for Arab investors, especially institutions like central banks and government agencies, still remains the U.S. bond/stock markets (the world's largest), though London, Paris, and Frankfurt have also been competing for abundant Gulf savings in recent years. True, some private investors after 9/11 have divested from the United States for political reasons and because of regulatory requirements of the USA Patriot Act.<sup>29</sup> Nevertheless:

It is a media myth that there has been a wholesale repatriation of Arab money from the US. GCC currency regimes are pegged to the dollar, GCC central bank reserves are overwhelmingly invested in the dollar, oil prices are invoiced and settled in dollars, the vast majority of the trillion dollar private and sovereign GCC wealth hoard is invested in dollar denominated securities and real estate. The smart money in the Gulf knows that investment logic, not politics or emotions, underwrites its historic overweight in American shares, bonds and properties. Sure, at the margin, perceived "expropriation risk" triggered private Saudi withdrawals from the US, but their funds were invested in Geneva, London, and Hong Kong offshore dollar assets.<sup>30</sup>

The reasons for the continued attractiveness of the United States as an investment destination for oil surplus can be traced to economic fundamentals: Overall the U.S. economy has proven resilient, flexible, and competitive compared with that of other industrial nations. This explains higher portfolio inflows and hence the steady demand for dollars. The IMF notes: "They [capital inflows into the United States] are unlikely to change direction abruptly since no other country or region enjoys the combination of robust growth and deep financial markets that the U.S. offers."<sup>31</sup> The dollar has also benefited from superior yield spreads relative to Japan and the eurozone in the past two years.<sup>32</sup>

The euro's appreciation up to early 2005 and China's revaluation of the renminbi (RMB) in mid-2005 have triggered a debate in the Gulf over the utility of exclusive dollar pegs, especially as a considerable share of GCC imports are from the euro area. However, the debate has remained largely academic, and a change of pegs—potentially combined with trading a share of oil in euros—does not appear im-

minent. Gulf governments are likely to keep current regimes until the planned currency union in 2010. Given greater stability in dollar assets, these will remain attractive, especially for cautious public investors. Nevertheless, a certain amount of diversification seems to be taking place.<sup>33</sup>

The fundamental shift in the ownership composition of excess savings in the world will not necessarily be negative for the dollar since for economic reasons OPEC countries in general should be as dollar-centric as Asian countries. But the way petrodollars are invested may make them more “footloose” than Asian official reserves.<sup>34</sup> Certainly large private-capital outflows are much more of a factor<sup>35</sup> than the case with China and its capital controls. Private Gulf funds and these funds are more likely to flow into higher-risk non-U.S.-denominated assets.<sup>36</sup> These flows may have been reinforced with the crash of Gulf stock markets in early 2006.<sup>37</sup>

These factors place a greater burden on the United States to maintain competitive interest rates and policy credibility and to convey a sense of prudence in order to retain these investments. It goes without saying that the United States must stem the increasing perception that it is anti-Arab or that its xenophobia will trump economics at critical junctures.

## **Assessment**

Despite repeated reports over the several years that the planned bourse would finally open for business on March 20, 2006, and go head-to-head with the New York Mercantile Exchange and the ICE Futures Exchange in London, the start date has been postponed to possibly some time in 2007.<sup>38</sup> Interestingly, the Iranian bourse was conceived at a time of a strengthening euro and a weakening dollar. It was also a time when many observers were attaching dire implications to the rising U.S. current-account deficits and a federal budget that seemed out of control.

In short, all signs were pointing to increasing stress on the dollar. In essence, this was the type of environment where perhaps one



more shock—a housing bubble or other financial malfunction—might push the dollar into a highly vulnerable range. In this environment the existence of a euro-denominated oil bourse might facilitate mass defections from and the rapid demise of the dollar—the straw that would break the dollar’s back. However, it was a time before the existence and implications of Bretton Woods II were clearly understood. It was also a period when most observers felt exchange rates were more affected by current-account imbalances than by real interest-rate differentials.

Today, things look very different; the dollar has been strengthening at times and remaining relatively stable at others. While the current account keeps on growing, U.S. real interest rates are very attractive and the euro is plagued with uncertainty over lagging growth and productivity rates, uncertainty over the constitution, and possible defections (Italy).<sup>39</sup> The Chinese are adamant that they will maintain their de facto link to the dollar—they are officially linked to a basket of currencies with the dollar presumably accounting for a large share of the dollar. Petrodollars are flowing into the United States to take advantage of that country’s broader and deeper capital markets.

In fact, all signs suggest that the de facto dollar zone is likely to persist for some time. Even as early as 1997, the writing seems to have been on the wall:

Incumbency is a strong advantage in the competition for reserve currency status. Both historical and econometric evidence point in this direction. The dollar being the reigning champion, it accounts for a larger share of global foreign exchange reserves than suggested by a simple comparison of U.S. and EU GDPs, and it should do so for some time to come. A more institutionally-oriented analysis reinforces the point. Reserve currencies are those which are issued by the governments of countries that are international financial centers. The United States gained its status as a financial center and the dollar its reserve-currency role only once the country acquired a central bank ready and willing to engage in day-to-day liquidity management and prepared to mount lender of last resort operations. The Maastricht Treaty does not foresee the European Central Bank as assuming comparable responsibilities. This will tend to slow the development of the euro zone as an inter-

national financial center and, by implication, limit the euro's reserve currency role.<sup>40</sup>

Far from being a threat to dollar-based oil pricing, and ultimately causing the demise of the dollar, the Iranian oil bourse is seen, at least by economists, more as a curiosity—a monument to uninformed, wishful thinking.<sup>41</sup> “To steal a phase from that inspired Middle Eastern thinker Fouad Ajami, the Iranian oil bourse would seem then to fit best with the many other Middle Eastern “dream places.”<sup>42</sup>

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