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The Legendary Ruler

The Energy Minister of Venezuela, Mr. Rafael Ramirez revealed that OPEC is likely to discuss creating a basket of currencies for oil pricing at its next summit as oil prices continue to rise on a tumbling dollar. The dollar has slid to record low against the Euro and a 26-year low against the pound while oil prices have reached a new record at USD 98 a barrel.

This report will begin by recounting how the dollar emerged as an international reserve currency after World War II and will proceed to examine the decline that the ruling dollar has witnessed in the recent past particularly against the rising euro. The report will then focus on discussing the impact of switching oil pricing from dollar to another currency (Euro) on the American economy and the global financial markets and in the light of these impacts will argue against any sudden change in oil pricing mechanism.

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Ideas of Conflict: From Petrodollars to Petro Euros?

“We do not rule out the possibility of pricing our crude oil exports in euros. That would be interesting for our European partners.”

Vladimir Putin, Russian President

“A switch to euros for oil trading will not happen in my lifetime...governments can make any statements they want, but that’s commerce.”

Bruce Misamore, Chief Financial Officer, Yukos

The dollar slid to record lows on November 6th against the euro to \$1.4666 and the Canadian dollar to \$1.0975 on speculation that China’s plans to diversify its foreign exchange reserves will involve selling US dollar denominated assets. Currently China holds over \$1.43 trillion in foreign reserves. The dollar also slumped to a 26-year low against the pound to \$2.0947 and a 23-year low against the Australian dollar to US cents 93.75. At the same time, crude oil rose above \$98 a barrel for the first time in New York.

Whether the dollar declined on expectations that the US Federal Reserve may cut interest rates to boost the slowing economy or on speculations that the economy of China which holds the highest levels of dollar reserves plans to diversify its reserve holdings or if the latter was driven by the former and simply reinforced the anticipated decline, what must be noted is the fact that dollar’s decline in the recent past has increased the attractiveness of commodities like oil as alternative investments. As a matter of fact, the weakness in the dollar is giving investors the chance to buy oil at a cheaper price and thus it is no surprise to see oil prices rise on a tumbling dollar.

In the wake of soaring volatility where the greenback is likely to remain weak and oil strong in coming days, the wild price action creates the potential for steep corrections market wide. Under these circumstances, the Energy Minister of Venezuela, Mr. Rafael Ramirez revealed that OPEC is likely to discuss creating a basket of currencies for oil pricing at its next summit. He stated, “The dollar as a benchmark currency has been weakening quite a lot and it creates distortions in oil markets.”

This has provoked a debate which is not too new in economic analysis as changing the oil pricing from dollar to particularly the euro has been a point of discussion since the time that dollar began to decline in 2001 and euro gained strength. In the following sections we will highlight this debate and analyze the impact that changing the benchmark currency on oil pricing will bring on the dollar, the US economy and the global financial markets.



The Global Currency

A reserve currency is a currency which is held in significant quantities by many governments and institutions as part of their foreign exchange reserves. It also tends to be the international pricing currency for products traded on a global market, such as oil and gold.


Ever since the days when the US dominated world oil production, sales of oil and natural gas on international markets have been exclusively denominated in dollars. This was partly a natural state of affairs since, up until the early 1950s, the US accounted for half or more of the world's annual oil production. The tendency to price in dollars was additionally reinforced by the Bretton Woods agreement which established the IMF and World Bank and adopted the dollar as the currency for international loans.

The fact that oil sales and loans from the IMF are dollar-denominated, the vast majority of the world's countries which are oil importers have been encouraged to keep the majority of their foreign currency reserves in dollars not only to be able to buy oil directly but also to protect the value of their own currencies from falling against the dollar. This is because a sudden devaluation of a country's currency against the dollar would lead to a jump in oil prices and a possible economic crisis. Hence every country's central bank needs dollar reserves so as to be able to buy its own currency on the foreign exchange markets when its value needs to be supported.

Reserves were formerly held only in gold, as official gold reserves. However, post World War II Bretton Woods System, the US dollar has emerged as the most significant reserve currency as central banks over the world typically hold large amounts of dollars as reserve currency.

Developing countries are also encouraged to denominate their exports in dollars as this minimizes the risk of losses through any fluctuations in the value of the dollar. The knock-on effect of this is that, since many of these exports are essential raw materials which developed countries need to import their denomination in dollars reinforces the need for developed countries to keep their own currency reserves in dollars as well. Hence it is not a surprise that almost 70% of the world's international currency reserves take the form of US dollars.

Having acquired the reserve currency status for its dollar, the US enjoys several advantages in having the dollar as an international reserve currency. Firstly the global use of the dollar, as with the global use of the English language, provides American businessmen with a great advantage over their foreign counterparts. It is more convenient for the country's importers and exporters, borrowers and lenders to be able to deal in its own currency than foreign currencies.



Secondly as a result of its international status, US banks have a comparative advantage in dealing with dollars. Only US banks have access to the safety net provided by US regulatory authorities (example, the ability to discount assets with the Federal Reserve).

Next is the advantage of seignorage. This is perhaps the most important advantage of having other countries hold one's currency. These countries must give up real goods and services or ownership of the real capital stock, in order to add to the currency balances that they use. There is another (smaller) component of seignorage in addition to the currency component. Most foreign central banks and other investors hold their dollars in the form of interest paying treasury bills. To the extent that the reserve currency role of the dollar allows the US Treasury to pay a lower interest rate on its liabilities than most other borrowers, the difference is a further source of seignorage.


And last but not the least is the political power and prestige that the US enjoys by having its currency as the primary international reserve currency. Thus the US has a great economic as well as political interest in maintaining the existing dollar based system. It is due to this interest that many political analysts have put forth the argument that the war with Iraq was not so much over fighting terrorism or oil as it was over the pricing of oil in euros by Saddam Hussein. This is because shifting the pricing of oil from dollar to euro is likely to have a devastating effect on the US economy.

However this report does not intend to judge the circumstances which provoked the war with Iraq. Instead in the following sections it aims to discuss the impact that shifting oil pricing from dollar to euro will have on the US economy and the global financial markets.

The Green Glory Faints

The dollar has lost its value significantly vis-à-vis major currencies of the world in the recent months on turbulent market conditions stemming from the ongoing US subprime crisis.

The decline in the value of the dollar has created major distortions in the market as reflected by the rising oil prices despite a slowing US economy. As the value of the dollar falls against currencies of major economies like Japan, Britain, Canada and European Union which are the biggest oil consumers, the price of oil falls in terms of their local currency. Low prices provoke these economies to stock excessive oil reserve. Hence the high demand for oil by these economies fuels high oil prices. The worst blow of high oil prices is felt by all emerging economies which still have their currency pegged to the dollar.



Referring to these market distortions, the Venezuelan Energy Minister revealed that in its next summit, OPEC shall discuss the possibility of creating a basket of currencies for oil pricing. It must be noted that this is not the first time that the issue of changing the benchmark currency for oil pricing has been brought up. It has rather been an issue of debate amongst economists and policy makers for some time now.

From November 2000 Iraq began to settle its oil exports in euro. And between 2001 and February 2003 almost the entire Iraqi oil export was paid in euros. During this period the euro had increased significantly in value relative to the US dollar. Since then the use of the US dollar as an international reserve currency has been declining gradually. In the past few years, this reduction in the share of dollar reserves has accelerated with the decline in the value of the dollar and the rise in the value of the euro which has emerged as a legitimate contender for reserve currency status.

Former Federal Reserve Chairman Alan Greenspan said recently that the euro could replace the US dollar as the world's primary reserve currency as it continues to soar against the US currency. The euro hit \$1.4666 on November 6th, the highest since the 13-nation currency debuted in January 1999.

The euro is currently the second most commonly held reserve currency, being approximately a quarter of total allocated holdings. After World War II and the rebuilding of the German economy, the German Deutsche Mark gained the status of the second most important reserve currency after the US dollar. When later the euro was launched in 1999, replacing the Mark and other European currencies, it inherited the status of a major reserve currency from the Mark. Since then its contribution to official reserves has risen continually as banks seek to diversify their reserves and trade in the euro zone continues to expand.

More and more developing countries are following the lead of Venezuela and China in diversifying their currency reserves away from dollars and toward euros. The oil-producing countries have also reduced their USD exposure. Crude exporters are reportedly shifting oil income into euros as well as to yen and sterling as a hedge against a continuing tumble in the USD. Such a shift in dollar holdings over the globe is likely to exert additional downward pressure on the dollar in the future.

In presence of current circumstances and distortions, therefore for OPEC a switch to euros or a basket of currencies could be driven more by concern over the long-term decline in the value of the dollar than anything else. Nevertheless any such shift is likely to have a devastating impact not only on the American economy but the global financial markets.



Revamping the Economic Globe

As mentioned earlier after World War II the dollar emerged as the most significant international reserve currency as emerging economies as well as the developed economies hold major portion of their foreign reserves in the form of US dollar.


The effect of an OPEC switch to the euro therefore would be that all oil consuming nations would have to flush dollars out of their reserve funds and replace these with euros. This would crash the dollar significantly in value. The foreign funds will stream out of the US stock markets and dollar denominated assets and we may witness a run on the banks much like the one in 1930s. The US current account deficit and the budget deficit, which has so far been financed by the rest of the world, would become unserviceable.

Moreover all emerging economies which currently have their domestic currencies pegged to the dollar will have to revamp their foreign exchange rate regimes; they will now have to peg their currency to the euro. Since 1997-98, following the Asian financial crises, most emerging Asian market economies have run a de facto or explicit peg against the US dollar. Though in recent months we have seen increased tolerance on part of these economies towards dollar depreciation, it is implausible to expect them to shift towards a euro-pegged regime.

Too big of a Change to happen?

At first sight, a shift in the pricing of oil to the euro may make a certain amount of sense. After all, the euro has managed a strong rebound in the past few years after falling steadily from its January 1999 flotation, regaining its losses. This undoubtedly suggests that the euro is a world class currency which is likely to hold its value and therefore does not seem to be at any major disadvantage versus the dollar. This is all the more evident when one compares the relative sizes of the economies involved, especially given the EU enlargement plans. EU has a bigger share of global trade than the US and while the US has a huge current account deficit, the EU has a more balanced external accounts position. Moreover though the US remains a large importer of oil, despite being a substantial producer itself, the EU is an even larger importer of oil and petroleum products than the US as a full 45% of OPEC's oil goes to Europe. EU thus represents for OPEC a more attractive market, closer and less domineering. Hence many politicians as well as policy makers might want to see oil traded in euros. Nevertheless we believe it probably will not happen in the foreseeable future for several reasons.

The first is simple convenience. Oil prices are determined by a complex interaction of spot, term and futures trading in different qualities of crude, based on benchmarks like North Sea Brent and West Texas Intermediate (NYMEX), both priced in dollars. If a euro



price or basket of currencies were intruded for one or more of the benchmarks, price-setting should become even more complex.


Next, shifting the benchmark currency for oil pricing from dollar to euro or any basket of currencies will result in sudden crash of the dollar. This will slip the US economy into a severe recession. However the impact does not stop here. Japan would be particularly hard hit because of total dependence on foreign oil and incredible sensitivity to the US dollar. China will also face sever challenges as 70% of US imports represents China's exports and American recession would mean a decline in demand for China's exports. If Japan's and China's economy tumbles, so does that of many other countries. What we will witness is a global meltdown. However it must be noted that this is the potential effect of a sudden switch to euros and a more gradual shift might be manageable but even a gradual shift is likely to change the financial and political balance of the world.

Most importantly, as mentioned earlier, most emerging economies have their currencies pegged to the dollar. In this way, any decision made by the Federal Reserve Bank of USA is likely to impact those of the central banks of these economies. This is because US monetary policy commonly impacts both interest rates and the value of the dollar and thereby economies which have to defend the dollar peg. In other words Fed dictates monetary policy to not just the US but to all economies which pursue a dollar pegged regime. A shift in oil pricing from dollar to euro would mean a shift in currency peg for these economies as oil and petroleum products constitute a huge portion of their imports and this in turn would mean looking up to the European Central Bank (ECB) as dictator of monetary policy rather than the Fed. As compared to Fed, ECB's policy is not tried and tested as ECB is a newborn institution with relatively short history.

Similar is the case with euro and dollar. The mighty dollar has reigned supreme since 1945. 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, 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 of global output. Euro on the other hand is a relatively new currency which was introduced less than a decade ago. Despite being at no disadvantage against the dollar currently there is no guarantee that euro will continue to gain strength versus the dollar in the coming years.

Wrapping Up....

The dollar decline has accelerated in the recent months against all major currencies, particularly the euro. And the Euro's fate is not tied solely to the dollar's whims. Rather, its renewed strength stems from a generally positive mood in Europe; one that is in stark contrast to the time when the collapse of the European constitution underscored deep



uncertainty about the future of the Continent. Hence as the dollar continues a relentless downward trajectory, it is the accelerating economic growth of Europe which is persuading investors to take shelter in the euro. In fact diversification of foreign reserves is already visible in some parts of the world. If the current economic scenario persists we will witness the Euro march ahead, slowly nibbling at the dollar's prestige. Nevertheless in light arguments of presented in this report we strongly believe that consideration of Euro as a reference currency across the globe is at least a generation away.



Economic Snapshot

Fiscal year 07-08														
	Units	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May	June	July	Aug	Sep
<u>Inflation</u>														
Headline Inflation	%	8.73	8.11	8.07	8.88	6.64	7.39	7.67	6.9	7.4	7.0	6.4	6.5	8.4
Core inflation	%	6.16	5.70	5.62	5.5	5.3	5.72	5.42	5.2	4.7	5.1	6.0	6.0	6.1
Food inflation	%	11.26	10.54	10.62	12.71	8.7	9.99	10.74	9.4	11.3	9.7	8.5	8.6	13
Non-food inflation	%	6.98	6.41	6.27	6.22	5.2	5.59	5.54	5.2	4.7	5.1	4.9	4.9	5
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.64	8.64	8.65	8.64	8.64	8.64	8.65	8.69	8.69	8.69	8.69	9.05	No bids
6 month	%	8.81	8.81	8.81	8.81	8.81	8.81	8.82	8.9	8.9	8.9	8.9	9.12	No bids
12 month	%	9.00	9.00	9.00	9.00	9.00	9.01	9.01	9.08	9.10	9.16	9.16	9.39	9.39
<u>External Sector</u>														
Export	Mln US\$	1,392	1,288	1,448	1,536	1,227	1,421	1,536	1,446	1,540	1,583	1,434	1,475	1,463
Import	Mln US\$	2,172	2,162	2,139	2,365	2,100	2,103	2,070	2,159	2,190	2,373	2,423	2,206	2,150
Trade balance	Mln US\$	(780)	(874)	(691)	(829)	(873)	(682)	(534)	(713)	(650)	(790)	(989)	(731)	(687)
<u>Remittances</u>	Mln US\$	422	410	448	475	391	457	520	513	537	505	495	489	516
<u>Forex Reserves</u>	Mln US\$	12,512	12,503	12,460	12,960	13,212	13,378	13,624	13,661	13,778	15,182	15,723	16,106	16,354



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