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BI-WEEKLY OIL REPORT

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"Why not oil price in euros?"

The question came from Russian President Putin who also added that pricing oil in euros is possible. Newspapers went as far as to suggest that a deal had been reached between Putin and German Chancellor Schroeder on the matter (German officials later rejected the reports). European Central Bank President Duisenberg suggested shortly afterwards that, although ECB holds a neutral stance, such a move could prove positive for both EU and Russia.

Russian President Putin, ECB President Duisenberg, US President Bush

The first time such a pricing issue arose was when Saddam Hussein insisted to sell Iraqi oil for the oil-for-food program in euros and not US dollars. UN granted him the right on November 2000, but the limited quantities Iraq exported and the fact that no other oil-producer followed Iraq's example, did not lead to any significant developments.

The effects for EU could be dual. We had noted in a previous report ("The relativity of prices" - June 11th 2003) how Europe has been able to benefit from the recent euro strength and lower its energy bill. The fact that oil was priced in dollars proved advantageous during the recent euro rise, but it had been exactly the opposite during the years of euro weakness. The main arguments supporting euro pricing for oil note that it will relieve European companies from the foreign exchange risk and it will contribute to the wider recognition of the euro as a dominant currency.

Oil producers exporting to Europe (like Russia) would have been more than happy if they had oil priced in euros during the recent rally. It is of no surprise, therefore, that President Putin raised the issue.

OPEC has been holding a wait-and-see attitude on the matter despite some sporadic threats, mainly from Iran, as its members may have conflicting interests in this issue. Those whose main exports target Europe would welcome the shift, while those mainly dealing with the US would most likely oppose it.

Two are, however, the main characteristics of this debate:

(1) The US does not openly participate in the discussion.
(2) The discussion itself is done very quietly and statements are seldom public, usually meant as a threat to the US.

The reason behind this is that even though the effects towards OPEC and non-OPEC producers, EU and Asian countries, could, depending on the circumstances, be both positive and negative, they will definitely be negative for the US. A substantial shift of the world economy's dependence on the USD will strike a direct blow in the heart of the US economy. Countries around the world are holding 70% of their reserves in USD and the majority of the funds invested by people worldwide are positioned in the US financial markets. Any significant change in this status quo will mean further weakening of the USD, higher inflation and US equities markets collapse. The threat to the prosperity of the average American becomes then evident.

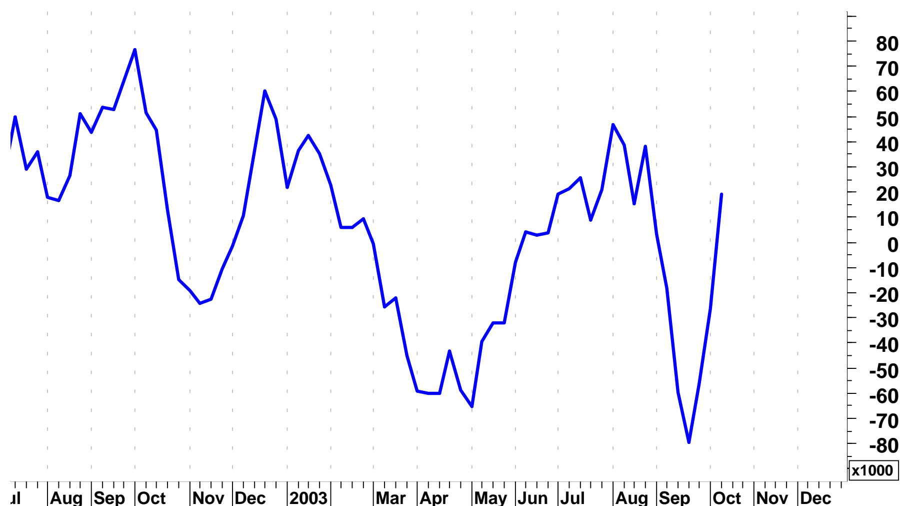
While oil pricing represents only part of the world's dependence on USD one could see, by simply multiplying the world annual demand with the average price of Brent for 2002, that countries need to hold more than $700 billion per year to pay for their oil needs (This is a very rogue measure of the petroleum cost, but nevertheless gives as an idea of the amounts involved in this issue). A shift of this USD amount to euros is more than Japan shifting all its foreign reserves to the European currency!

It is therefore clear why US is not participating in the discussion and why all major interested parties are very careful and subtle when bringing the matter up. It is very unlikely, that as long as the US retains its political and military clout, it will allow a widespread shift in the pricing mechanism of such a strategic commodity such as oil. It is thus clear that any aggressive effort to change the current status quo will draw heavy US criticism and major strain in bi-lateral relationships.

We would therefore conclude, that despite the attention that Putin's statements have drawn, it does not seem likely that we will see major changes in the short-term regarding this issue.

As far as the markets were concerned, funds continued their roller coaster ride, vindicating our previous report, by completely reversing their short crude position of 79,350 contracts on Sep. 23rd to a net long position of 19,339 contracts on Oct 14th. This reversal of 98,689 contracts cannot be simply justified by the fact that OPEC decided to raise output and it shows that more aggressive strategies are implemented during the last months.

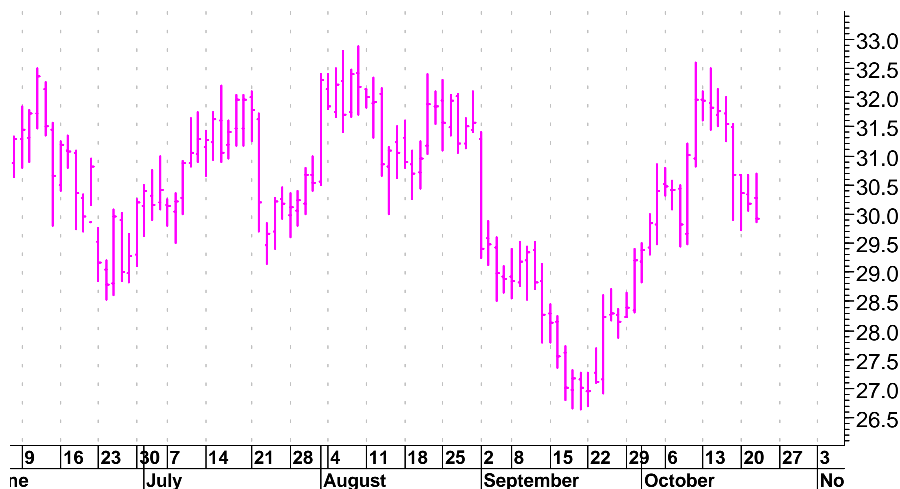
Figure 1. NYMEX crude oil futures non-commercial+non-reportable net position (thousands of contracts)



Source: NYMEX

To support this point further we should note that few days after reporting this net long position prices dropped from $32's to a low of $29.90 and are today trading around the $30 level, signaling that funds may be once again reversing their bets.

Figure 2. NYMEX WTI crude oil price



Source: NYMEX

The drop of Oct. 17th, the fact that petroleum supplies seem to be reaching global markets without obstacles and the steady rise in US inventories, have created a fairly bearish environment. This environment could become even more bearish if rumors that Saudi Arabia and other OPEC countries have started once again to be concerned about their market share, become louder. Saudi Oil Minister Naimi repeated his commitment to $25 per barrel crude, while OPEC officials noted that they would be willing to raise production if OPEC basket crude remains above $28 for 20 days. This will happen on Nov. 5th, if prices continue to remain at current levels. OPEC will most likely wait until their Dec.4th meeting before deciding what to do with output, but it seems that they will more than welcome a drop of $1-$2 until then.

If no major supply shock takes place in the meantime it seems that oil markets will likely do them the favor.

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